TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1942

No. 552

INTERSTATE TRANSIT LINES, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

PETITION FOR CERTIORARI FILED NOVEMBER 28, 1942.

CERTIORARI GRANTED MARCH 8, 1943.

SUPREME COURT OF THE UNITED STATES

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[fol. a] [Caption omitted]

[fol. 1]

BEFORE UNITED STATES BOARD OF TAX APPEALS

Docket No. 101692

UNITED STATES BOARD OF TAX APPEALS, INTERSTATE TRANSIT LINES, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

ORDER EXTENDING TIME TO FILE RECORD TO APRIL 25, 1942

Upon motion of counsel for petitioner and consent of counsel for the respondent, it is

Ordered that the time for preparation of the evidence and transmission and delivery of the record sur petition for review of the above entitled proceeding in the United States Circuit Court of Appeals for the Eighth Circuit be and it is hereby extended to April 25, 1942.

J. E. Murdock, Member.

Dated: January 17, 1942. Washington, D. C.

[File endorsement omitted]

BEFORE UNITED STATES BOARD OF TAX APPEALS

[Title omitted]

DOCKET ENTRIES

Appearances:

For Taxpayer: Henry W. Clark, Esq., Harry J. Gerrity, Joseph F. Mann, Esq.

For Comm'r: Henry C. Clark, Esq.

[fol. 2] 1940

Mar. 8—Petition received and filed. Taxpayer notified. (Fee paid).

Mar. 8—Copy of petition served on General Counsel.

1940

Mar. 8—Request for circuit hearing in New York, New York, filed by taxpayer. 3/8/40 copy served.

Mar. 25—Motion to consolidate with docket 101693 filed by taxpayer.

Apr. 6—Answer filed by General Counsel.

Apr. 6—Request for circuit hearing in Omaha, Nebraska filed by General Counsel. 4/16/40 Denied.

Apr. 17—Request for circuit hearing in New York City filed by taxpayer. Granted.

Oct. 25—Hearing set Jan. 6, 1941, New York City.

Oct. 25—Hearing set Jan. 6, 1941, New York City on motion.

1941

Jan. 21—Hearing had before Mr. Leech on the merits. Submitted. On motion of petitioner to withdraw previous motion to consolidate with 101693, granted. (Separate Hearings). Appearance of Joseph F. Mann, Esq., and stipulation of Facts filed. Motion to withdraw previous motion to consolidate with 101693, filed at hearing. Petitioner's brief due March 6, 1941; Respondent's brief due 4/17/41; Petitioner's reply brief due 5/8/41.

Jan. 27—Transcript of hearing Jan. 21, 1941 filed.

Mar. 6—Brief filed by taxpayer. 3/6/41 copy served on General Counsel.

Apr. 17—Brief filed by General Counsel.

May 14—Motion for leave to file the attached reply brief, reply brief lodged, filed by taxpayer.

May 16—Copy of motion and reply brief served on General Counsel.

July 9—Findings of fact and opinion rendered, Mr. Leech, Div. 6. Decision will be entered for the respondent. 7/9/41 copy served.

July 9—Decision entered, J. Russell Leech, Div. 6.

[fol. 3] Aug. 7—Motion for reconsideration of findings of fact and opinion filed by taxpayer. 9/3/41 Denied.

Nov. 26—Petition for review by United States Circuit Court of Appeals, Eighth Circuit, with assignments of error filed by taxpayer.

Nov. 26—Proof of service of petition for review filed by taxpayer.

1942

Jan. 17—Agreed motion for extension to 4/25/42 to prepare, transmit and deliver the record, filed.

Jan. 17—Order enlarging time to April 25, 1942 to prepare, transmit and deliver the record, entered.

Feb. 2—Agreed statement of evidence lodged.

Feb. 2—Præcipe for record filed by taxpayer—with proof of service thereon.

Feb. 4—Agreed statement of evidence approved and ordered filed.

BEFORE UNITED STATES BOARD OF TAX APPEALS

PETITION—Filed March 8, 1940

The above named Interstate Transit Lines, petitioner, hereby petitions for a redetermination of its income tax liability and of the deficiency for the year 1936 found by the Commissioner of Internal Revenue, respondent, in his deficiency letter addressed to petitioner, designated SN-IT-1, dated December 13, 1939.

I

Petitioner

The petitioner herein was in 1936, and still is, a corporation of the State of Nebraska, with its executive office at 2116 Leavenworth Street, Omaha, Nebraska. For purposes of this proceeding, however, petitioner's address is C/o [fol. 4] Union Pacific Railroad Company, 120 Broadway, New York City, N. Y.

II

Deficiency Letter

On December 13, 1939, respondent mailed to petitioner a letter dated said day (a copy of which is hereto annexed, together with the supporting statement which accompanied it, marked Exhibit A), which letter is hereinafter referred to as the "deficiency letter".

III

Deficiency Found

The additional tax proposed by the deficiency letter for the calendar year 1936 is $4,461.53. The amount in controversy for said year is $3,923.03.

IV

Assignments of Error

Petitioner asserts that in the redetermination of its income tax liability for the year 1936, as set forth in the deficiency letter, respondent has erred in the following particulars:

A. In not allowing as a deduction a payment made by petitioner to a wholly-owned subsidiary, Union Pacific Stages of California, which payment, the amount of the deficit incurred by the subsidiary in its operations for the year 1936, was made pursuant to the terms of a valid contract.

V

Facts

The facts upon which petitioner relies in support of the foregoing assignments of error are as follows:

1. The petitioner is a corporation organized and existing under the laws of the State of Nebraska.

2. Petitioner during the year 1936 was, and still is, engaged, together with two wholly owned subsidiary com- [fol. 5] panies hereinafter mentioned, in the operation of motor buses for the transportation of passengers as a common carrier subject to the Motor Carrier Act of 1935 (49 Stat. 543) over various routes between Chicago, Illinois, and Los Angeles, California.

A—Union Pacific Stages of California

Operating Loss

3. In the year 1932 and continuing through 1936, the California Statutes (Public Utilities Act, Section 50 1/4, Deering's General Laws of California, Act 6386, page 3161) provided:

"No passenger stage corporation shall hereafter operate or cause to be operated any passenger stage over any public highway in this state without first having obtained from the railroad commission a certificate declaring that public convenience and necessity require such operation, * * *."

During such period the Railroad Commission of California refused to grant such certificate of public convenience and

necessity except to corporations organized and existing under the laws of the State of California.

4. In order to be able to do an intrastate business in California which would supplement its interstate business, petitioner caused the Union Pacific Stages of California (hereinafter referred to as the "Stage Company") to be organized under the laws of the State of California as a wholly-owned subsidiary, and since 1932 petitioner's California business, both intrastate and interstate, has been conducted by the Stage Company and petitioner has done no business in California.

5. To insure the uninterrupted transportation of its interstate passengers to and from points in California, petitioner, effective February 7, 1932, entered into an agreement with the Stage Company, a copy of which is [annexted] hereto and marked Exhibit B, under which, among other things, the Stage Company agreed to operate buses upon such routes and upon such schedules and under such operating rules and regulations as petitioner might direct, and in consideration therefor petitioner agreed to assume, and to reimburse the Stage Company for, any deficits incurred by [fol. 6] it in its operations and the Stage Company agreed to pay the petitioner any profits resulting from its operations.

6. In order to insure further the uninterrupted transportation of its interstate passengers to and from points in California, petitioner, under date of February 8, 1932, entered into an agreement with the Stage Company, a copy of which is annexed hereto, marked Exhibit C, which provided, among other things, that the buses of each company would operate through on their respective runs beyond the California state line but that at the state line the buses would pass into the custody and possession of the other company and that the employees would become the employees of the company having the custody and control.

7. During the year 1936, the deficit incurred by the Stage Company in its operations amounted to $28,100.66.

8. Pursuant to the terms of said contract of February 7, 1932, Exhibit B hereto, petitioner became obligated to pay and did pay to the Stage Company in 1936 said sum of $28,100.66.

9. The accounts of both petitioner and the Stage Company were, for 1936 and prior years, kept upon an accrual basis.

VI

Relief Prayed

Petitioner prays that its income tax liability for the year 1936 be redetermined by this Board upon the several errors herein assigned and the facts pleaded in support thereof.

Wherefore, petitioner prays that this Board hear and determine its tax liability upon the issues herein set forth.

Dated March 5, 1940.

Henry W. Clark, 120 Broadway, New York City, N. Y.; Harry J. Gerrity, Hill Building, Washington, D. C., Counsel for Petitioner.

[fol. 7] *Duly sworn to by J. L. Haugh. Jurat omitted in printing.*

For Exhibits "B" & "C" see Exhibits 1 & 2 attached to Statement of Evidence.

Exhibit A to Petition

SN-IT-1

Treasury Department

Internal Revenue Service

Omaha, Nebraska

December 13, 1939.

Omaha Division
676 Saunders-Kennedy Building

Interstate Transit Lines, 2116 Leavenworth Street, Omaha, Nebraska.

Sirs:

You are advised that the determination of your income tax liability for the taxable year(s) ended December 31,

1936 discloses a deficiency of $4,461.53 as shown in the statement attached.

[fol. 8] In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to Internal Revenue Agent in Charge, Omaha, Nebraska for the attention of LLN:90D. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully, Guy T. Helvering, Commissioner, by T. P. Smith, Internal Revenue Agent in Charge.

Enclosures:
Statement.
Form of waiver.

Statement

Interstate Transit Lines,

2116 Leavenworth Street,

Omaha, Nebraska

Tax Liability for the Taxable Year Ended December 31, 1936

	Liability	Assessed	Deficiency
Income Tax	$83,209.78	$78,748.25	$4,461.53

Explanation of Adjustments

(b) The amount of $28,100.66 claimed as a deduction under Item 25(c) of your income and excess-profits tax [fol. 9] return as "Loss of Wholly Owned Subsidiary Union

Pacific Stages of California Absorbed under Contract" is disallowed for the reason that no provision of the Revenue Act of 1936 authorizes such a deduction.

Computation of Tax

Income tax:	
Normal tax:	
Net income for normal tax computation	$585,078.99
Less: Interest on U. S. obligations	22,613.82
Normal tax net income	$562,465.17
8% of $ 2,000.00 (Over ..... 0 to $ 2,000)	$ 160.00
11% of $13,000.00 (Over $ 2,000 to $15,000)	1,430.00
13% of $25,000.00 (Over $15,000 to $40,000)	3,250.00
15% of 522,465.17 (Over $40,000)	78,369.78
Total normal tax	$ 83,209.78
Total surtax	None
Total tax assessable	$ 83,209.78
Income tax assessed (Normal tax and surtax):	
Original, account No. 400566	78,748.25
Deficiency of income tax	$ 4,461.53

For Exhibits "B" and "C" see Exhibits 1 and 2 Attached to Statement of Evidence

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Exhibit D to Petition

This Agreement made as of the seventh day of February, 1932, by and between Interstate Transit Lines, a corporation organized and existing under the laws of the State of Nebraska, (hereinafter called Transit Lines), party of the first part, and Interstate Transit Lines, Inc., a corporation organized and existing under the laws of the State of Illinois, (hereinafter called the Illinois Corporation), party of the second part,

Witnesseth:

Recitals: The Illinois Corporation is a subsidiary of, and all of its capital stock is owned by, Transit Lines. [fol. 10] Transit Lines operates busses between various points but operates no busses within the State of Illinois. The Illinois Corporation operates busses in the State of Illinois and also to Milwaukee, Wisconsin. The Illinois Corporation is maintained as an operating subsidiary of Transit Lines and its operations are conducted solely for the benefit of Transit Lines. In order that Transit Lines may obtain the greatest benefit from the operations of the Illinois Corporation it is necessary that the schedules of the Illinois Corporation be coordinated with the schedules of Transit Lines, and that the Illinois Corporation operate on such routes and upon such schedules as will most greatly benefit Transit Lines. Since such operation may not be so remunerative to the Illinois Corporation as operation solely for its own corporate benefit, the parties hereto have agreed that during the term of this agreement such coordinated bus operation shall be carried on under the terms and conditions hereinafter set out.

Now, therefore, the parties hereto mutually agree as follows:

First. The Illinois Corporation agrees to operate busses upon such routes and upon such schedules, and under such operating rules and regulations, as may be directed by Transit Lines.

Second. Transit Lines agrees to assume and to reimburse the Illinois Corporation for any deficits incurred by the Illinois Corporation in its operations. The Illinois Corporation agrees to pay over to Transit Lines any profits resulting to the Illinois Corporation from its operations. Payments hereunder shall be made only at the end of each calendar year. The deficit or profit, however, shall be calculated for each calendar month separately.

Third. This agreement shall be effective as of the seventh day of February, 1932, and shall continue in full force and effect until terminated by notice as herein provided. Either party hereto may terminate this agreement on the last day of any calendar month by notice delivered on or before that day to the other party hereto.

In Witness Whereof the parties hereto have caused this [fol. 11] agreement to be executed by their respective officers thereunto duly authorized, and under their respective corporate seals, as of the date first above written.

Interstate Transit Lines, by R. J. Walsh, President.

Witness: A. C. Phillips.
Attest: C. B. Matthai, Secretary.

Interstate Transit Lines, Inc., by R. J. Walsh, President.

Witness: A. C. Phillips.
Attest: C. B. Matthai, Secretary.

EXHIBIT E TO PETITION

This Agreement, made and entered into this seventh day of February, 1932, by and between Interstate Transit Lines, a corporation of the State of Nebraska (hereinafter called "Nebraska Company"), party of the first part, and Interstate Transit Lines, Inc., a corporation of the State of Illinois (hereinafter called "Illinois Company"), party of the second part, Witnesseth:

Recitals:

The Nebraska Company has been operating a passenger motor coach transportation business from points west, north and south of Omaha, Nebraska, through Omaha and through the States of Iowa and Illinois, to Chicago, Illinois, and from Chicago to Milwaukee, Wisconsin, doing only an interstate business in the State of Illinois. The Illinois Company, a subsidiary of the Nebraska Company, con- [fol. 12] templates engaging in certain intrastate motor coach operations in the latter state and it has been arranged between the parties hereto that the Illinois Company, in addition to performing said intrastate operations, will take over as successor of the Nebraska Company all motor coach operations heretofore performed by the Nebraska Company in the State of Illinois and in Wisconsin to Milwaukee. The Nebraska Company will therefore terminate its motor coach operations at the Mississippi River and there connect with the motor coach lines of the Illinois Company. For convenience and economy of operation it is desirable that the buses of each party, except buses engaged in operations

local to its territory, run through from its territory into the territory of the other party. The Illinois Company may need, for operations local to its territory, buses in addition to those owned by it and the Nebraska Company is willing to furnish such additional buses on the terms hereinafter stated.

Agreement:

Now Therefore, it is mutually agreed by and between the parties hereto as follows:

Section 1. The buses of the Nebraska Company operating from points west of the Misissippi River (except those engaged in operations local to its territory) shall on each trip continue through east of said river, and at said river shall pass into the custody and possession of the Illinois Company. The buses of the Illinois Company operating from points east of said river (except those engaged in operations local to its territory) shall continue through west of said river, and shall pass into the custody and possession of the Nebraska Company at said river. Each party shall during the term of this agreement, and hereby does, lease its buses to the other party while so in the custody and possession of such other party, subject to the terms and conditions hereinafter stated.

[fol. 13] The Nebraska Company agrees to lease to the Illinois Company, subject to the terms and conditions hereinafter stated, such buses as the Illinois Company may need, in addition to those owned by it, for operations local to the latter's territory, and such buses shall, if and when furnished to the Illinois Company, automatically come under this agreement and be subject to the terms and conditions hereof.

Section 2. The owning party is hereinafter for convenience designated as the "Lessor" and the party to which said buses are leased is hereinafter designated as the "Lessee". The Lessee shall pay to the Lessor monthly a sum of money equal to Five Cents (5c) for each and every mile run by each bus of the Lessor while in the custody and possession of the Lessee. The Lessee shall bear and pay that portion of the expenses of maintaining and operating said buses (other than drivers' wages and taxes) and of insurance thereon, including fire, public liability and property damage, which is properly attributable to

said buses while in its possession. The drivers of buses involved in this agreement shall be the sole employes of, and their wages shall be paid by, the Lessee while such drivers are in service in connection with leased buses in the custody and possession of the Lessee. Each party shall pay taxes on its own buses. Adjustment of accounts as between the parties hereto shall be made monthly as soon after the first of each month as practicable.

Section 3. The Lessee shall be responsible to the Lessor for the buses of the Lessor while in the Lessee's custody and possession.

Section 4. This agreement shall take effect on the date first herein written and shall continue in full force and effect until terminated by written notice given by either party hereto to the other on any date in such notice stated, not less, however, than thirty (30) days subsequent to the date on which such notice shall be given.

[fol. 14] In witness whereof, the parties hereto have caused this agreement to be executed in duplicate as of the date first herein written.

Interstate Transit Lines, by R. J. Walsh, President.

Witness: John A. Bennewitz. (Seal.)
Attest: C. B. Matthai, Secretary, ITL.

Interstate Transit Lines, Inc., by R. J. Walsh, President.

Witness: John A. Bennewitz. (Seal.)
Attest: C. B. Matthai, Secretary, ITLI.

Approved as to form: John A. Bennewitz, General Attorney.

BEFORE UNITED STATES BOARD OF TAX APPEALS

[Title omitted]

ANSWER OF COMMISSIONER OF INTERNAL REVENUE—Filed April 16, 1940

Comes now the Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and in answer to the petition filed in the above-entitled proceeding, admits and denies as follows:

I. Admits that the petitioner herein was in 1936, and still is, a corporation of the State of Nebraska, with its [fol. 15] executive office at 2116 Leavenworth Street, Omaha, Nebraska. Denies the remaining allegations contained in paragraph I of the petition.

II. Admits the allegations contained in paragraph II of the petition.

III. Admits that the additional tax proposed by the deficiency letter for the calendar year 1936 is $4,461.53. Denies the remaining allegation contained in paragraph III of the petition.

IV. A and B. Denies that the Commissioner erred as alleged in subparagraphs A and B of paragraph IV of the petition.

V. 1. Admits the allegations contained in subparagraph 1 of paragraph V of the petition.

2. Denies the matter contained in subparagraph 2 of paragraph V of the petition, except it is admitted that petitioner during the year 1936 was engaged in the operation of motor buses for the transportation of passengers between Chicago, Illinois, and Los Angeles, California.

3 to 6, inclusive. Denies the matter contained in subparagraphs 3 to 6, inclusive, of paragraph V of the petition.

7. Admits the allegations contained in subparagraph 7 of paragraph V of the petition.

8 to 13, inclusive. Denies the matter contained in subparagraphs 8 to 13, inclusive, of paragraph V of the petition.

Denies generally and specifically each and every allegation contained in the petition not hereinbefore specifically admitted, qualified or denied.

Wherefore, it is prayed that the Board redetermine the correct amount of deficiency involved in this proceeding to be equal to the amount determined by the Commissioner, [fol. 16] namely, $4,461.53 in income tax for the year 1936, and that the petitioner's appeal be denied.

J. P. Wenchel, Chief Counsel Bureau of Internal Revenue.

Of Counsel: R. P. Hertzog, Division Counsel; Gene R. Reardon, Special Attorney, Appeals Division.

BEFORE UNITED STATES BOARD OF TAX APPEALS

Docket No. 101692

UNITED STATES BOARD OF TAX APPEALS, INTERSTATE TRANSIT LINES, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

FINDINGS OF FACT AND OPINION OF UNITED STATES BOARD OF TAX APPEALS—July 9, 1941

Petitioner, a bus transportation company, has not established its right here to deduct as its ordinary and necessary business expense the operating deficit of its subsidiary, to the payment of which petitioner was committed by contract with the subsidiary.

Henry W. Clark, Esq., and Joseph F. Mann, Esq., for the petitioner.

Henry C. Clark, Esq., for the respondent.

Respondent determined a deficiency in income taxes of $4,416.53 against the petitioner for the calendar year 1936. The only issue submitted is whether the petitioner is entitled to a deduction of $28,100.66 as an ordinary and necessary expense of carrying on its business for that year.

FINDINGS OF FACT

The petitioner is a corporation created by the State of Nebraska, with its executive offices located at Omaha, Nebraska, where it filed its income tax return for the calendar year 1936. Since 1929 the petitioner has operated interstate bus transportation lines between Chicago, Illi- [fol. 17] nois, and Los Angeles, California; and between Kansas City, Missouri, and Cheyenne, Wyoming, for the transportation of passengers, mail, and express. In addition to this interstate business, petitioner had acquired the right to handle intrastate business in the states along its routes, in the States of Iowa, Nebraska, Kansas, Colorado, Wyoming, Utah, and Nevada.

Petitioner could not then acquire the right to do intrastate business in California because the Public Utilities Act

of California required the certificate of the Railroad Commission for conducting a common carrier business on the public highways, and that commission, based on its interpretation of that act, refused to grant certificates for intrastate operations to foreign corporations.

Petitioner, for the purpose of augmenting its income from carrying California intrastate traffic, which could be done without substantial increase in its facilities or expenses, and because of its inability to thus function, in 1930 organized a subsidiary corporation, under the laws of California, under the name of Union Pacific Stages of California, hereinafter called "Stages", which company, by 1932, had secured certificates authorizing it to conduct the desired intrastate operations. Petitioner furnished all its capital and received all its capital stock. On February 7 and 8, 1932, respectively, petitioner and Stages executed two contracts. The first of these, hereinafter called the "Absorption Agreement", recited that Stages was a wholly owned subsidiary of the petitioner, that it was maintained as an operating subsidiary of the petitioner and its operations conducted solely for the benefit of that company, and that, in order that the petitioner might obtain the greatest benefit from the operations of Stages, it was necessary that Stages operate on such routes and schedules as would most benefit petitioner. It provided that Stages would operate busses on such routes and schedules as directed by petitioner, in consideration for which petitioner agreed to assume and reimburse Stages for any operating deficits incurred by that company, and that Stages agreed to pay over to petitioner any operating profit resulting from its operations at the end of each calendar year. The second contract, hereinafter called the "Operating Contract", provided that Stages, in addition to its intrastate business in California, should conduct all of the interstate operations theretofore performed by petitioner in California. The [fol. 18] agreement provided that when the busses crossed the Nevada state line, they should pass into the custody and possession of the respective companies there operating. It was further provided that as the respective companies took over the custody and possession of the busses, a payment to the owners of 5 cents per mile run by each bus should be made and the "lessee" would be responsible to the "lessor" for the busses of the "lessor" in the "lessee's" custody and possession. In operating under this agreement there was

no change in the conduct of the business except that intra-California passenger and other transportation was available on the busses thus operating. No additional expense was incurred except the cost of petitioner keeping the separate accounts for Stages. At the outset, Stages acquired a local franchise from the Pickwick-Greyhound lines, together with two busses.

The stock of Stages was all owned by petitioner, and these companies had the same directors and officers. The above contracts were executed by the same persons as officers of the respective companies. Stages had its own accounting records, employees, busses, directors, and corporate minute book. Its accounting records were kept at the offices of petitioner by the officers and employees of petitioner, who kept petitioner's records.

Stages had no bank account. Petitioner collected all the revenues of Stages and paid all of the bills, pay roll and otherwise, of Stages.

All revenues from operations of both companies were collected by petitioner and all expenses of both companies were paid by the petitioner. Monthly, petitioner apportioned on the books of the respective companies the revenues of the respective companies on the basis of passenger and traffic miles, compared to the aggregate of the same. Likewise, the expenses were apportioned except those, such as taxes, which were charged to the company liable therefor. The entry of these items was made in an open account of petitioner with Stages. A corresponding open account with petitioner was kept on the books of Stages. These accounts were designated cash accounts.

On the books of each company there was kept another open account with the other company which was used exclusively as a "clearing account" for the entry at the end of each year showing the absorption by the petitioner of the profit or deficit of the operation of Stages for the year. [fol. 19] For the calendar year 1936, involved here, Stages incurred an operating deficit of $28,100.66, as shown by its books. As of December 31, 1936, that amount was charged to petitioner in the "clearing account" of Stages with petitioner, and, as of the same day, that amount was credited to Stages in the "clearing account" of petitioner with Stages.

As of December 31, 1936, before the foregoing entries were made, Stages on all open accounts was indebted to peti-

tioner in a net amount of about $34,000, so that the foregoing entry reflecting the so-called "absorption" of the alleged deficit of $28,100.66 of Stages for that year merely reduced the net indebtedness of Stages to petitioner, otherwise existing, by the amount of that alleged deficit, and left Stages indebted to petitioner in an amount exceeding $5,000.

For the years 1932 and 1933, during which returns of affiliated companies were permitted, such returns were filed for petitioner and Stages.

Several years after 1936, because of an amendment to the California Public Utility law or a modification of the Railroad Commission of California's interpretation of it, removing the inability of petitioner to obtain authority to conduct intrastate business in California, Stages was dissolved and liquidated and its assets, leases, and franchise transferred to petitioner, with the approval of that commission.

The accounts of both petitioner and Stages have at all times been kept on an accrual basis.

Opinion

Leech: The petitioner seeks to deduct $28,100.66, the amount of the operating deficit of Stages for the year 1936, as shown on the respective books of petitioner and that company, as an ordinary and necessary expense in carrying on its business during that year. Sec. 23 (a), Revenue Acts of 1934 and 1936.

Respondent, by his contested determination, denies not only the right of the petitioner to deduct the item as an ordinary and necessary business expense, but apparently says also that the mechanics used do not constitute an accrual in fact of these items, since no cash settlement of the accounts between petitioner and Stages was made [fol. 20] until the dissolution of the latter in a year subsequent to 1936. We decide the issue on the first ground and pass the second.

Deductions are permissible, of course, only by legislative grace and, to avail itself of their benefit, the taxpayer must conform squarely with the legislation authorizing them. New Colonial Ice Co. v. Helvering, 292 U. S. 435. It is not necessary that either respondent or we characterize this accrual from an accounting standpoint. Connally

Realty Co., 31 B. T. A. 349; affd., 81 Fed (2d) 221; Baltimore & Ohio Railroad Co., 29 B. T. A. 368. Thus, to succeed here, petitioner has the burden of establishing that the contraverted accrual was an ordinary and necessary expense of its business.

Stages was a separate, juristic taxable entity. Higgins v. Smith, 308 U. S. 473; Burnet v. Commonwealth Improvement Co., 287 U. S. 415. Its business was that of furnishing intrastate transportation within California. That was not and could not have been the business of petitioner, which, so far as California was concerned, was restricted to interstate business. The bus business of Stages, limited as it was to the State of California, did not become that of petitioner by virtue of petitioner's sole ownership of the stock of Stages. All Russian Textile Syndicate, Inc. v. Commissioner, 62 Fed. (2d) 614; certiorari denied, 289 U. S. 752; Alexander M. Bing, 30 B. T. A. 429; Mary E. Cappon, 28 B. T. A. 357. Stages was not organized, its stock was not acquired, and the contested accrual thereunder was not made by petitioner to increase the profits of the business of petitioner. Those facts were deliberately brought about by petitioner to augment its income by increasing the income of Stages, its wholly owned subsidiary, from the intra-California business of the latter company in which petitioner could not engage. The accrual in controversy thus may well have been in the nature of a capital expenditure and not an expense at all. Cf. Welch v. Helvering, 290 U. S. 111.

Moreover, whether any or all of the operating deficit of Stages for the taxable year was attributable to the intra-California business of that company is not disclosed. Whether that business was necessary to profitable operation of petitioner's interstate business in California does not even appear. In fact the opposite conclusion is at least inferable. Profit to its subsidiary in the California intrastate business was the motive which moved petitioner. [fol. 21] The contested accrual was made pursuant to the contract of February 7, 1932. All the capital stock of Stages, one party to that contract, was owned by petitioner at the time of the acquisition of that contract and throughout the life of the former company. Stages was therefore always entirely under the control of petitioner. Assuming therefore that the item in question was an expense of petitioner's business, on this record, including the absence

of evidence as to the ordinary and necessary expense of furnishing interstate transportation to and from within California, we do not think the petitioner has sustained its burden of establishing that any part of the operating deficit of Stages for the taxable year was an ordinary and necessary expense of the petitioner in the operation of its interstate business. Main Central Transportation Co., 42 B. T. A. 350. Cf. Welch v. Helvering, supra.

Respondent is sustained.

Decision will be entered for the respondent.

(Seal of U. S. Board of Tax Appeals.)

Before United States Board of Tax Appeals

United States Board of Tax Appeals Washington Interstate Transit Lines, Petitioner,

v.

Commissioner of Internal Revenue, Respondent

Order of Redetermination, July 9, 1941

Decision

Pursuant to the determination of the Board, as set forth in its Findings of Fact and Opinion, promulgated July 9, 1941, it is

Ordered and Decided: That there is a deficiency in income tax of $4,461.53 for the calendar year 1936.

Enter:

Entered July 9, 1941.

J. Russell Leech, Member.

(Seal of U. S. Board of Tax Appeals.)

[fol. 22] Before United States Board of Tax Appeals

Motion for Reconsideration, and Denial Thereof—Filed August 7, 1941. Denied September 3, 1941

Now Comes, Interstate Transit Lines, petitioner in the above entitled proceeding, and petitions for a reconsideration of the Findings of Fact made, and of the conclusion

reached in the Opinion, in the report herein, promulgated on July 9, 1941.

The sole issue involved in this review proceeding before the Board is respondent's disallowance of the deduction, as an ordinary and necessary expense of the business of petitioner, of the 1936 deficit of its wholly-owned subsidiary, the Union Pacific Stages of California, hereinafter called "Stages". The proposed affirmance of respondent's disallowance of the deduction rests upon the conclusion that petitioner did not sustain its burden of establishing that any part of the operating deficit of Stages was an ordinary and necessary expense of petitioner in the operation of its interstate business.

The Findings of Fact

We address this motion first to the Findings of Fact made in the report.

A very careful record was made in behalf of petition, addressed, of course, to establishing the ultimate fact as to which a failure of proof has been found. Indeed, at the hearing we feared that the testimony offered concerned such minute details as to the conduct of the business and affairs of petitioner and the Stages, that it might seem tiresome to the presiding Member.

The facts proposed in petitioner's first brief were carefully formulated and sustained in every respect by the record. While the facts so proposed in behalf of petitioner have in general been found in the report, the findings of fact as made omit all or part, or modify the statement of, the facts proposed in six paragraphs of petitioner's first brief. We feel that, although some of the omissions and modifications appear small, in the aggregate the facts found by the Board fall sufficiently short of the facts proposed in behalf of petitioner to justify this motion for reconsideration of the findings of fact.

[fol. 23] We submit that every proposed finding of fact omitted from, or materially modified in statement by the Board's findings, has weight, in greater or less degree, as bearing on the result reached in the Board's opinion. We urge that none of the requests which are hereinafter made be rejected because of a thought that it is immaterial or unimportant. The court must get its factual basis and background solely from the facts as they may be finally

found, for the court did not have the benefit of hearing the testimony.

First request:

The first eight lines and two words of the ninth line of page 2 of the report are an extraordinary and wholly unnecessary condensation. They dispose in two sentences of six subjects: (1) The fact of the organization of a California subsidiary, (2) for the purpose of augmenting petitioner's income, (3) with no substantial increase in expenses, and (4) because of petitioner's own inability to do California local business, (5) the securing of Commission certificates for local business by the California subsidiary, and (6) the furnishing of the capital and issuing of the capital stock of the California Subsidiary.

We feel that this extreme condensation unduly prejudices petitioner in that it greatly dilutes and subordinates the record made as to the reason for organizing the Stages. Paragraph 4 of petitioner's proposed facts was a statement in the language of witness Haugh (Tr., p. 31) of the sole reason for creating the California company. His statement is strong and emphatic. Petitioner should not lose the benefit of the exact language of his testimony on this point.

Again, the phrase in the second and third lines of page 2 of the findings as to no "substantial increase" in petitioner's facilities or expenses might be interpreted as conflicting with or qualifying the finding, in lines 8th and 9th from the end of page 2, that there was no additional expense except some bookkeeping cost. The latter location, following as it does the facts about the "Operating Contract", is the more appropriate. We prefer the finding of no expense, above mentioned.

So, we request that there be substituted for the first two sentences of the findings on page 2, being the first eight [fol. 24] lines and two words on the ninth line, the following:

Petitioner, being unable itself to secure a certificate for handling local traffic in California, caused to be organized in 1930 a subsidiary corporation under the laws of California under the name of Union Pacific Stages of California, hereinafter called "Stages". (Tr., pp. 18-19.) There was one reason and one reason only for creating a California

subsidiary, and that was to enable the parent company through the agency of the California company, to secure a certificate of public convenience and necessity from the California commission to handle intrastate passengers within the State of California and thereby augment its gross revenue and its net income. (Tr., pp. 30-31.) Petitioner furnished all the capital for and received and owned all the capital stock of Stages. (Tr., pp. 61 and 95.) At the outset Stages acquired by purchase a local franchise from the Pickwick-Greyhound Line, with the approval of the State commission, together with two buses, and by additional applications secured Commission certificates by 1932, which together constituted local franchises from the Nevada-California state line to San Bernardino, California. (Tr., pp. 5, 18, 19.)

The above text corresponds with petitioner's proposed facts, paragraphs 3 and 4, and the last sentence of paragraph 9.

Second request:

The findings in respect of the provisions of the "Operating Contract" beginning about the middle of page 2 follow in general paragraph 6 of the proposed facts in petitioner's first brief, but with some change of language. However, there has been omitted the provision as to drivers. We request that this provision be restored as being an important feature of the actual operations. The sentence as to the change in the custody and possession of the buses at the state line is awkward. and we suggest a restatement simply as an improvement of the language. The bus rental provision is unimportant and can be shortened.

So, we suggest the following as a revision of the text of the two sentences beginning in the 19th line from the end [fol. 25] of page 2 and ending in the 12th line from the end of that page.

The agreement provided that the buses operated by either company to the California-Nevada state line, upon crossing that line, should pass into the custody and possession of the other company; that the buses should be subject to a rental payment to the owning company; that the drivers of the buses should be the employes solely of and their wages paid by the company having the custody and possession of the buses; and other provisions were made as to the apportion-

ment of expense of maintaining and operating the buses and insurance, and as to taxes. (Exhibit C to petition.)

Third request:

We ask, for the sake of accuracy in the narrative, that there be inserted in the 12th line from the end of page 2 of its report, as an additional sentence following the period, the following:

The two agreements aforesaid, described as the Absorption Agreement and the Operating Contract, at all times governed the accounting of both companies and were strictly observed.

This finding was requested in paragraph 11 of petitioner's proposed facts and is supported by the testimony at page 61 of the Transcript.

Fourth request:

There is a faulty expression in the 10th line from the end of page 2 of the report, in the exception to the finding that in operating under the operating agreement there was no change in the conduct of the business. The exception reads: "except that intra-California passenger and other transportation was available on the busses thus operating." This is an inexact statement.

We request that there be substituted for the text just quoted the following:

except that California passengers for travel between local points were available to the through buses. The buses theretofore operated by petitioner continued to be operated to and from Los Angeles, with the same drivers and on the [fol. 26] same schedules as theretofore. There was no break in the operation of the buses or change of passengers at the California-Nevada state line.

The first sentence of the above suggested substitute merely corrects the text of the finding. The second and third sentences accord with paragraph 8 of the petitioner's statement of proposed facts and are supported by the testimony (Tr. pp. 23-24 and 28). Their addition is of some importance in giving an understanding of the way in which the operations of the two companies were conducted.

Fifth request:

We request that there also be added to the findings, following the amended and additional text above stated under our fourth request, the following:

The advantage of obtaining the California local business through Stages was that petitioner had been operating its interstate buses to and from Los Angeles, California, and there were vacant seats in all the buses on the California part of the route, so that, by having the intrastate franchise, it was possible to obtain local passengers to occupy such vacant seats.

This proposed additional text was not specifically requested as a finding in petitioner's first brief. It is proved by the testimony (Tr., pp. 24 and 15), and we think its addition will further clarify the operating situation. We hope this text may be added.

Sixth request:

We suggest that the sentence in the 7th to 9th lines from the end of page 2, reading: "At the outset, Stages acquired a local franchise from the Pickwick-Greyhound lines, together with two busses." be struck out. The information is covered in substance by the finding now in lines 6 to 8 of page 2, and will be covered in detail if petitioner's "First request", for the revision of the first few lines of page 2, is granted.

[fol. 27] Seventh request:

We again propose the finding, stated in paragraph 10 of the proposed facts in petitioner's first brief, and accordingly request that the following be found:

It was assumed prior to the formation of Stages that there was available local business between points in California along the route of petitioner's interstate buses to the amount of $10,000, and while separate account of the revenue from local business has not been kept, the officers of petitioner believe that such revenue exceeded that amount annually and did so in 1936 (pp. 23-24).

The best place for the insertion of the above text is at the end of the text requested as an additional finding in our foregoing "Fifth request".

This requested addition, we admit, is not important, but it seems no more than fair to give the Court some information as to the probable amount of the California local business.

Eighth request:

The sentence in the 4th and 5th lines from the end of page 2 is a partial duplication. It reads: "The stock of Stages was all owned by petitioner, and these companies had the same directors and officers." It has already been found in the 8th and 9th lines of page 2 that petitioner acquired all the capital stock of Stages. We request, therefore, that this duplication be eliminated and the sentence confined to the identity of directors and officers as between the two companies.

Ninth request:

The last complete sentence on page 2 reads: "Stages had its own accounting records, employees, busses, directors and corporate minute book." This finding is literally supported by testimony found in the transcript at pages 33 and 55. The affirmative answers, which could not have been intended literally in the light of other testimony, were brought out by a series of questions apparently more or less rhetorical and designed to show merely that Stages was a separate corporate entity — "a separate, juristic taxable entity", as it is characterized in the opinion. There is no [fol. 28] dispute about this on the part of petitioner. But the quoted sentence seems objectionable in its implication of an entirely separate and independent organization and staff. Of course, any such implication as to accounting records is qualified by the following sentence which shows that the accounting records of Stages were made at the offices of petitioner by the same people who made petitioner's records. As to buses, it appears in a previous finding that Stages acquired two buses. As to directors, the second preceding sentence finds that petitioner and Stages had directors and officers in common. As to employees, a finding which we have requested concerning the bus drivers will show that they also were common employees. Nevertheless this sentence seems somewhat objectionable and we request that there be substituted for it the following:

Nevertheless Stages was a separate corporate entity for income tax and other purposes and it was always recognized as such by petitioner.

Tenth request:

The report in the 4th paragraph of page 3 contains the finding: "For the calendar year 1936, involved here, Stages incurred an operating deficit of $28,100.66, as shown by its books." Then follows a finding as to the charging and crediting of this deficit in the intercompany clearing accounts. We request that at the end of this paragraph there be added the following:

The deficit would have been greater without the local business in California (transcript, page 71).

This additional text was not requested in petitioner's first brief, but we think it is desirable that the finding as to the 1936 deficit have this small clarification.

The Opinion

We address this motion, in the second place, to the opinion of the Board in the report promulgated on July 9, 1941. We do so very briefly, because we advanced in petitioner's first brief, on pages 9 to 11, and 14 and 15, the facts of record and the considerations which we thought supported the allowance of the Stages' deficit as an ordinary and necessary expense of petitioner's business. The Board [fol. 29] Member who presided at the hearing concludes that our proof was inadequate, and the argument in our first brief was evidently not convincing to the contrary. There is probably no justification for our asking a reconsideration of the final conclusion in the Opinion. We do so only because it seems that there must be a misunderstanding either on our part or on the part of the Board Member as to some of the testimony, and indeed, as to one of the findings made.

It is stated in the opinion, on page 5, as follows:

"Moreover, whether any or all of the operating deficit of Stages for the taxable year was attributable to the intra-California business of that company is not disclosed."

It is this statement in the opinion to which we have referred in suggesting that there is some misunderstanding involved in the opinion. It has been found as a fact that "No additional expense was incurred except the cost of petitioner keeping the separate accounts for Stages." We understand

the Court's finding as meaning that the conducting of local bus operations in California, that is, the transportation of passengers between California local points on buses which had been and were to continue to be operated in any event for interstate traffic, caused no increased expense. That is the fact, according to the undisputed testimony. That being so, it necessarily follows that no part of the deficit in question was attributable to the local business. An operating "deficit" is an excess of operating expenses over revenues. Since no expense was incurred in transporting the California local passengers, there could be no deficit from the local operations. It seems to us that the Board member must have some different understanding of the facts, including the meaning of his own finding as to the absence of any additional expense. But we submit that no other understanding of the testimony is justifiable.

Since none of the deficit in question resulted from a California local business, it necessarily is a deficit incurred in the California part of the interstate bus operations as allocated to Stages in the apportionment of interstate revenues and expenses. If Stages had not been organized, the same deficit (in fact, a somewhat larger one) would have [fol. 30] existed inevitably, although it would not have been an ascertained amount in the absence of an apportionment to California of the revenues and expenses of interstate operations.

Upon organizing Stages and making the Absorption Agreement and the Operating Contract between the two companies, the necessity of an apportionment to California of the interstate revenues and expenses became necessary for the first time. The only effect in such apportionment of the revenues from California local passengers was that such revenues increased the profit or decreased the deficit otherwise shown as the apportionment to California of the interstate revenues and expenses.

We concede fully to Stages the status of a separate, juristic taxable entity. We may concede also recognition of separate business operations by petitioner and Stages to the utmost extent justified from the most legalistic standpoint. Nevertheless, the Absorption Agreement and the Operating Contract cannot be ignored; they must be accorded at least the same effect that would be given them if they were contracted between corporations wholly unrelated

by stock ownership, or, directors and officers, and such concession ignores the recital in the Absorption Agreement (page 15 of Petition) that the operations are "conducted solely for the benefit of" petitioner. The purpose of these agreements was to provide Stages with the use of buses on which local passengers could be transported, and at the same time continue petitioner in the enjoyment of any profit which it had theretofore realized from its interstate operations into Southern California, but subject to the continuance of its liability for the expenses of such operation.

The contractual relations created between the parties did not give rise to any new liability or expense; they were intended merely to leave the net result of the operations into Southern California with petitioner, just as they had been before, except for the slight improvement in the result due to additional revenue from California local passengers. The intended result was accomplished from the accounting standpoint. We believe that there is no reason why the result may not be given its appropriate effect under the tax law.

[fol. 31] Wherefore, it is prayed that the foregoing requests for changes in the findings of fact made in a report of the Board promulgated July 9, 1941 be granted, and that the opinion in said report be reconsidered, and its ultimate conclusion withdrawn.

Henry W. Clark, Joseph F. Mann, Darwin P. Kingsley, Jr., 120 Broadway, New York, N .Y.; Harry J. Gerrity, Hill Building, Washington, D. C., Counsel for Petitioner.

Dated: New York, N. Y., August 6, 1941.

Denied September 3, 1941,

J. Russell Leech, Member, U. S. Board of Tax Appeals.

BEFORE UNITED STATES BOARD OF TAX APPEALS

[Title omitted]

PETITION FOR REVIEW—Filed November 26, 1941

Interstate Transit Lines, Petitioner, is aggrieved by a decision of the United States Board of Tax Appeals rendered on the 9th day of July 1941, in the case of Interstate

Transit Lines, Petitioner, vs. Commissioner of Internal Revenue, No. 101692, and the denial by the United States Board of Tax Appeals on the 3d day of September 1941 of motion of the Petitioner for a reconsideration thereof, determining that there is a deficiency of Petitioner's federal income tax for the year 1936 in the amount of $4,461.53, [fol. 32] and respectfully submits its petition for a review thereof by the Circuit Court of Appeals for the 8th Circuit.

I

Venue

The Petitioner's income tax return for the year 1936 was filed in the office of the United States Collector of Internal Revenue for the District of Nebraska, located in the 8th Judicial Circuit.

II

Nature of the Controversy

The controversy involves the determination of the Petitioner's federal income tax for the calendar year 1936. The sole issue involved in this appeal is that designated A in its petition to the Board and entitled "Union Pacific Stages of California—Operating Loss." Petitioner claims the right to deduct as an ordinary and necessary expense incurred in its business, the sum of $28,100.66, which represents the deficit incurred by Petitioner's wholly owned and completely dominated subsidiary, Union Pacific Stages of California (herein referred to as "Stages"), which deficit was absorbed by Petitioner and the amount thereof paid to said subsidiary under an agreement dated February 7, 1932, between Petitioner and its said wholly dominated and controlled subsidiary.

Assignment of Errors

The Board of Tax Appeals erred in its decision in the following respects:

In refusing to allow Petitioner in computing its 1936 net income to deduct as an ordinary and necessary expense incurred in its business, an item of $28,100.66, which represents the deficit of Petitioner's wholly owned and completely dominated subsidiary, Union Pacific Stages of California,

which sum was absorbed and paid by Petitioner to said subsidiary pursuant to an agreement dated February 7, 1932 between Petitioner and its said wholly owned and completely dominated subsidiary, and more particularly the [fol. 33] following rulings as the basis of such refusal:

(a) In holding that the contested accrual of $28,100.66 "may well have been in the nature of a capital expenditure and not an expense at all."

(b) In holding that "whether or not any or all of the operating deficit of Stages for the taxable year was attributable to the intra-California business of that Company is not disclosed."

(c) In failing to hold that intra-California business reduced the deficit which Stages would have suffered in the through business taken over from petitioner.

(d) In holding that "whether the intra-California business was necessary to profitable operation of petitioner's interstate business in California does not even appear."

(e) In holding that the conclusion is at least inferable that the intra-California business of Stages was not necessary to the profitable operation of petitioner's interstate business in California.

(f) In holding that profit to its subsidiary in the California intra-state business was the motive which moved petitioner.

(g) In failing to hold that increased profit in the entire operation of the bus business as a whole by petitioner and its subsidiaries was the motive which moved petitioner to turn over the California through business to Stages which, as a California corporation, secured a license to do an additional California intra-state business.

(h) In failing to hold that in the conduct of interstate and intrastate business within the borders of California, Stages was a mere agent or instrumentality of the petitioner.

(i) In holding that petitioner did not sustain its burden of establishing that any part of the operating deficit of Stages for the taxable year was an ordinary and necessary expense of the petitioner in the operation of its interstate business.

[fol. 34] (j) In failing to hold that petitioner was obligated, under the contract of February 7, 1932, to reimburse Stages for any deficits incurred in its operation.

(k) In failing to hold that such reimbursement by petitioner to Stages was an ordinary and necessary expense of petitioner's business.

(l) In failing to make the several findings of fact requested by the petitioner, and each of them, as set out in the motion for reconsideration.

Dated: November 25, 1941.

Henry W. Clark, Attorney for Interstate Transit Lines.

Nelson Trottman, Of Counsel.

Duly sworn to by Leo J. Tracy. Jurat omitted in printing.

[fol. 35] Before United States Board of Tax Appeals

[Title omitted]

Statement of Evidence

The following is a statement of evidence submitted to the Board of Tax Appeals in the above entitled case so far as is necessary to the assignment of errors heretofore filed, reduced to narrative form:

This proceeding came on for hearing before Honorable J. Russell Leech, a member of the United States Board of Tax Appeals, on the 21st day of January, 1941, at 201 Varick Street, New York, N. Y. Henry W. Clark, Esq. and Joseph F. Mann, Esq., appeared for the taxpayer, and Henry C. Clark, Esq., appeared for the Commissioner. After statements of the case for both the taxpayer and the Commissioner were heard, the following testimony was introduced with respect to the issues on appeal:

Jesse L. Haugh called as a witness on behalf of the Petitioner, being first duly sworn, testified as follows:

Direct Examination.

Note: For convenience the Petitioner is referred to as the Nebraska company and the Union Pacific Stages of California is referred to as the California company.

My name is Jesse L. Haugh and my residence is Omaha, Nebraska. I am a Director and Vice-President of Interstate Transit Lines, the petitioner. I have been a Director of that company since July 1, 1929, and Vice-President since 1935. The Nebraska company since my acquaintance with it in 1929 has conducted the business of transporting passengers, mail and express over a route from Chicago to Los Angeles and from Kansas City through Denver to Cheyenne, connecting with the first named through route, by motor bus on the public highway. It has not engaged at any time in any other business.

Beginning with my directorship in 1929 I have really been the Managing Director of the Company and have had a [fol. 30] substantial part in the development of the policies and in the organization and in the management.

Mr. R. J. Walsh has been President during the entire period. His attention to the business has been confined largely to operations of the company. It is the other matters that have been in my special charge, although I have been acquainted with the operations, too.

The through routes of the operation that I referred to, from Chicago to Los Angeles and from Kansas City through Denver to Cheyenne, were first established for interstate business.

Thereafter the Company applied to each of the state commissions for certificates to handle intrastate passengers, mail and express, that is, to handle passengers between the cities in the same state. It did that in the states of Iowa, Nebraska, Kansas, Colorado, Wyoming, Utah and Nevada. It has not at any time done any local business, that is, intrastate bus operation in California. The Nebraska company never obtained a certificate from the California Commission authorizing it to do any intrastate business in California because it was the policy and the practice of the State Railroad Commission of California to grant certificates for intrastate operations to local companies only, that is, to companies incorporated in the State of California and it would have been futile under the practice of the Commission for the Nebraska company to have applied for a certificate. It was a matter of policy adopted by the Commission and it was the manner in which the Commission construed the California law, that it could not grant such a certificate. That policy was well known to representatives of the Nebraska company.

It was considered in 1929 and in the immediately following years that there was a desirable amount of intrastate passenger bus traffic available in California. Our review of that indicated that there was a substantial amount of revenue that could be added to the interstate schedules. To obtain that local business the first step was to organize a company with an incorporation in the State of California because that was the only way by which the Commission would grant the right. That company was organized and named the Union Pacific Stages of California. That California subsidiary succeeded in obtaining local franchises. [fol. 37] It secured local franchises extending from the Nevada-California state line westward to San Bernardino. The first was secured through a transfer of a certificate that was bought from the Pickwick Greyhound Lines in 1932. The transfer from the Pickwick Greyhound Lines required and received the approval of the California Commission. Although the California subsidiary was organized in 1930, it was not in a position until some time in 1932 to operate. That was because the State Commission did not grant more than one franchise over a given route so that it was necessary first to secure a franchise that might be transferred to the new company.

I am familiar with the original agreements of February 7, 1932, and February 8, 1932, copies of which are printed with the petition and designated Exhibits B and C. I have personally compared those particular exhibits with the original agreements. The printed exhibits are exact copies of the original agreements. The original agreements, of which those are copies, were made between the Nebraska company and the California company at or about the dates I have indicated.

Counsel for Petitioner: I offer in evidence Exhibit B attached to the petition.

Counsel for Respondent: The Respondent interposes an objection to the receipt in evidence of Exhibit B upon the following grounds: It is not competent for parties to any agreement to undertake thereby to determine in any manner how it will affect the computation of Federal income or profits taxes, the allocation of items of income or of deductions from income and the document offered can have no other purpose in this case.

The Member: That is the only basis of your objection?

Counsel for Respondent: Of course, I will also add the usual objections that it is irrelevant and immaterial to any of the issues here.

The Member: Objection overruled and exception to the Respondent.

Counsel for Petitioner: Now, I offer Exhibit C attached to the petition in evidence.

Counsel for Respondent: I have no objection to Exhibit C.

The Member: Received. Let the record show that those exhibits are received here as Petitioner's Exhibits 1 and 2.

[fol. 38] (Exhibits B and C received and marked Petitioner's Exhibits 1 and 2 respectively of this date,) in evidence.)

I have with me the originals of those two agreements. I examined them yesterday. I am familiar with the signatures of the officers who executed them. They were there and I saw their particular signatures.

After the making of these agreements, the California end of the bus business of the Nebraska company was continued pursuant to Exhibit C, the operating agreement.

Under the operating agreement which is Exhibit C, Exhibit 2 as admitted in evidence, the interstate business between those lines was treated as conducted by the California company rather than by the Nebraska company, although the Nebraska company had, prior to the making of the agreement, operated through to Los Angeles. Insofar as passengers were obtained between the points of origin and destination in California, that local business was treated as handled entirely by the California company.

We estimated at the time that there would be about $10,000 added to the revenue by reason of intrastate business. Although we have never kept the accounts separate as to the revenue from the intrastate business and interstate business, it probably exceeds that amount, and did in 1936.

The advantage from the standpoint of the Nebraska company in obtaining that California local business through a California subsidiary was that: The Nebraska company had been operating the interstate buses to California and there were vacant seats in all the buses, so that it was possible by having the intrastate franchise and by handling local passengers to obtain additional passengers without additional

expenses, the gross revenue being carried frequently to net income. The local business was handled on the same buses that had been operated previously by the Nebraska company. The same buses, same schedules, no additional schedules added nor any additional buses, nor any additional agents or stations established. There were no physical changes whatsoever in operation created by the formation of the California subsidiary.

There were changes in bookkeeping only, setting up the separate accounts for this new company. No additional expense was created by the California local business, unless [fol. 39] it would be a slight additional expense in accounting, opening a new set of books.

The bus terminal in Los Angeles was first secured by the Nebraska company. Then, after the California company was formed, it was transferred to the California company and in 1936 stood in the name of the California company. It was a leased terminal.

The depots in California were generally operated by the bus line on a basis whereby they were to pay a commission to the owner of the place, the drugstore or restaurant, hotel, filling station, and that commission would cover the use of the premises. The labor of selling the tickets and those agency agreements were on behalf of the California company in the State of California after the California company was formed.

There was a garage lease at Los Angeles which was first taken in the name of the Nebraska company and then when the California company was formed that was transferred to the California company.

Referring to the so-called depot arrangements, that is, stopping places where passengers can buy tickets, there were no more of those after the addition of the local service than before. Those agencies were opened by the Nebraska company for the interstate business; for instance, a sale of a ticket from Victorville, California, to Salt Lake City, Utah, or from Victorville to Las Vegas, Nevada, or some place out of the state. The same agencies that sold interstate became the agencies for intrastate tickets.

After the execution of the contract, which is Exhibit C to the petition, the California company purchased two buses as its proportion of the equipment. These were purchased from the Pickwick Greyhound Lines when the franchise and the equipment was bought from them in 1932, at the

beginning of the California company's operation. Then those two buses operated in a pool with the parent company's buses. In after years through 1936 no additional buses, in addition to those first two, were acquired for or allotted to the California company.

As to officers of the two companies: The Nebraska and California companies had five directors. They were exactly the same directors at all times. Each company had a President, a General Superintendent, Traffic Manager, Auditor, [fol. 40] Assistant Treasurer, Secretary, and those officers were concurrent, that is, the same men were occupied with the same positions on the California company that they had on the Nebraska company. The direct charge of operations —immediate charge, was vested in a Superintendent at Los Angeles who had jurisdiction over the territory in California and from the California line to Las Vegas, Nevada.

There was no actual break in the operation of buses or change of passengers from one bus at the California and Nevada state line after the California company assumed the operations in California. The buses operated through from Salt Lake City, Utah, about 800 miles west to Los Angeles and about 300 miles of that distance was in the State of California, and the balance in the State of Nevada and in the State of Utah. There was no difference at all in crossing the state line, that is, the same bus operated through from Salt Lake City to Los Angeles.

In the creation of the California subsidiary and the agreements made between it and the Nebraska company, there was no purpose to affect income taxes whatsoever.

I would like to add to that, with the approval of counsel, that we hesitated and did not want to form this California company. It became necessary in order to augment the income of the parent company to do it. After having formed it, we wanted to make it as simple as possible because in the matter of management we were not concerned as to what either company separately made, but what the parent company made through the second company.

To do that, it was necessary to consolidate all the expenses and revenue and frankly, I never paid any attention and neither did Mr. Walsh, the President, pay any attention, to the California company because those were absorbed by this agreement by the earnings of the parent company and it wasn't necessary to look upon this rather arbitrary division of revenue and expenses.

There was one reason and one reason only for creating the California company, and that was that the parent company through the agency of the California company, might secure a certificate of public convenience and necessity from the California Commission to handle intrastate passengers within the State of California and thereby augment its gross revenue and its net income.

[fol. 41] That was the sole purpose. When, afterwards, the law was modified, I think in 1937, the California company was immediately dissolved. In other words, sometime after the year 1936, which is the tax year, we were able either by reason of a change in the law or by reason of a change in the views of the California Commission to dispense with the California company and we did do that. The California company was actually dissolved and all of its assets and leases and operations were transferred to the Nebraska company. With the approval of the Commission the franchises and operating rights were transferred to the Nebraska company and are now being operated by the Nebraska company.

The Member: That is to say, you are now doing an intra and interstate business in California by the taxpayer here.

The Witness: Yes, sir, that was made possible by a change in the law in 1937.

Cross-examination.

By Mr. Henry C. Clark (Counsel for Respondent):

Q. This contract, Exhibit B, and also the contract, Exhibit C, attached to the petition, which have been offered as Petitioner's Exhibits 1 and 2, are executed, by each of them, by the President of the respective companies who was the same individual and with the same name.

A. Yes, sir, the same name and the same man.

Q. Mr. Haugh, would you want to advise the California Railroad Commission that this California subsidiary while it was in operation was a mere dummy or subterfuge?

A. It was not a subterfuge, sir, and further than that, before the California company was organized, the California Railroad Commission was advised entirely about it and approved it.

Q. You had a separate corporation, of course?

A. Yes, sir.

Q. And that is what you told the California Railroad Commission you would do?

A. Yes, sir.

Q. And you had separate books?

A. Yes, sir.

Q. There is no doubt it was a separate institution?

A. It was a separate incorporation.

[fol. 42] Q. With its own accounting records?

A. Yes, sir.

Q. Its own employees?

A. That is correct, sir.

Q. And its own separate business?

A. That is correct.

Q. And continued in that condition for five years or more?

A. Yes, sir.

Q. And that was the situation in 1936?

A. That is correct.

Q. Do you have any connection with the Union Pacific Railroad Company?

A. Yes, sir, Vice-President.

Q. How long have you held that office?

A. Since 1929.

Q. The California company insofar as any agreements of any form were required for carrying out the business in California entered into such agreements itself, did it not?

A. That was necessary, that the Nebraska or parent company could, through a very necessary agency, augment its income.

Q. But when the California company started in business, it really was in business?

A. Yes, sir.

Q. Doing business?

A. Yes, sir.

Q. Making agreements every day?

A. I wouldn't say that.

Q. Well, selling tickets?

A. Yes, sir, selling tickets.

Q. There probably wasn't a moment of the day but when it had busses running on the road, is that right?

A. That is right.

Q. And it had its own Directors meetings?

A. Yes, sir.

Q. And its own separate corporate minute book?
A. Yes, sir.
[fol. 43] Q. And the Directors met for the California company from time to time?
A. That is correct.

WADE A. HALL called as a witness on behalf of the Petitioner, being first duly sworn, testified as follows:

Direct examination.

My residence and office is in Omaha, Nebraska. I am the auditor of the Nebraska company and have occupied that position since December 1, 1930. I am also the auditor of the California company, the Union Pacific Stages of California. I have had that position ever since the operation started. I think it was organized prior to December. The function of the auditor of these bus companies is to require accounting reports covering the operation of the company. To properly account for the revenue and expenses of the corporation. I am generally in charge of their accounting and am the head of the Accounting Department. The actual book entries are made by bookkeepers in my department, but I or some subordinate of mine directs what the entries shall be. The accounts of both companies have at all times been kept on the accrual basis. I have brought from Omaha the ledgers and journals of the two companies covering the period from 1928 to 1938, that is, the Nebraska company and the California company to 1938. The stock of the California company at all times since its organization—I do not mean registered ownership necessarily, but the actual ownership—has been owned by the Nebraska corporation.

I am familiar with the two agreements of February 7 and February 8, both in 1932, between the California and Nebraska companies, which have been introduced in evidence here. Those agreements have governed the accounting of the two corporations. In the accounting I have had done for the two corporations, the contracts have been strictly observed. The California company does not have a bank account. The Nebraska corporation has. The California company never has had any bank account. The method of handling the revenues and expenses of the Cali-

fornia company by the Nebraska company in its capacity of [fol. 44] its banker is as follows: In the first instance, the Nebraska corporation collects all the money and pays all the bills. The intrastate revenue is assigned to the California company. Transactions in which the California company had some interest are booked in open account with the California company. The California company has an open account on its books with the Nebraska company. The general officers of the Nebraska company are the general officers of the California company and receive salaries. There is an apportionment of their salaries made with the California company. In the case of employees of the Nebraska company below the classification of general officers, but referring to employees who participate to some extent in the conduct of the California business, they are carried on the Nebraska company payrolls. The Stages company has no payroll. Those employees are paid by Interstate Transit Lines payroll vouchers—its checks, because the California company has no bank account on which to draw pay checks. Their compensation as shown by the payroll is for their Interstate Transit Lines service, whether performed in California or in other states, without an attempt to segregate it on the payroll. And finally, as to those employees, they do not receive any separate pay check from their services in California.

At the beginning of its operation (California company) in 1932, the Nebraska corporation paid for the buses allocated to the California company originally and transferred them to the California company through open account. The arrangement was that the California company would take the two buses from the Pickwick Greyhound Lines. However, the Nebraska corporation paid for the buses and in doing so transferred the cost to the California corporation through open account. And on the California company's books, that cost was charged to a property investment account. Intrastate revenue that was local to the State of California was assigned direct to the California corporation, and to the California corporation is apportioned their share of interstate passenger revenue on the passenger mile basis.

Payroll was apportioned among the companies on the basis of the ratio of the revenue motor coach miles of the California company to the total revenue motor coach miles for the particular month involved. That apportionment

was computed monthly. In the apportionment of revenue, [fol. 45] when the apportionment for the California company has been determined, entries are made on the Nebraska corporation's books turning the amount over through open account to the California corporation, and the California corporation sets the revenue up in its revenue accounts carried in open account on its books with the Nebraska corporation. And after the payroll apportionment has been made, the California company's share of the payroll for the month is charged in the open account on the Nebraska company's books. It is set up in the operating expenses of the California company. There is an apportionment made of fuel consumed on the mileage basis,—revenue motor coach basis. Cost of repairs is apportioned on the revenue motor coach miles as explained for the payroll. Miscellaneous expenses are accorded the same treatment. All revenues and expenses received and paid by the Nebraska company are booked first by it without any apportionment, just as if they were its own receipts and expenses, and then at the end of the month the apportionments which I have mentioned are made. The California company's apportioned share as computed is credited or charged in the open account. Then for the first time only is there any bookkeeping to be done for the Stages Company as to the apportioned revenue. There are some items, however, which are directly booked on the California company's books without apportionment. These are payments made by the Nebraska company for capital expenditures for the California corporation. They are handled in the open account of the California corporation, and likewise on the California corporation books the amounts are set up in investment account. Capital expenditures made for the California company would not get into its income accounts nor in its expense accounts. And taxes paid by the Nebraska corporation for the California corporation are charged through the open account to the California corporation, but not subject to any apportionment; also depreciation of the California buses. I have referred several times to the open account, which includes capital advances in which capital advances are entered. There is also a second open account on the books of each company that is used solely for the debiting or crediting of the profit or loss at the end of each year under the absorption agreement, which is Exhibit 1 in evidence. That profit or loss,

as the case may be, is determined solely from the income [fol. 46] account of the California company and expense accounts and tax accounts and depreciation accounts—operating revenue and expense statement, the difference between the two. The second open account does not in any way reflect any capital expenditures or capital transactions.

The method of accounting which I have described has been the same from the beginning of the California company's operations through 1936. It would be hard to determine whether the keeping of separate accounts for the California company has caused additional expense. There would be some because you have more entries to make and naturally there would be more cost. The account books cost something and it would take time to make the entries, and the ink costs something. It would be hard to say whether it meant an additional employee or additional bookkeeper or other employee because, as I mentioned, in making these entries and recording them,—the items in the accounts,—there are a certain portion of several clerks' time involved here. It would be hard to set it down. The work of my department has been increasing all the time so that a gradual increase in my force has been going on due to various causes, partly due to increase of general business and State requirements with respect to Court records and Interstate Commission reports. I have 67 employees in my department at the present time. That includes not only bookkeepers but stenographers, chief clerks, bureau heads and office boys.

Consolidated returns were filed for 1932 and 1933 by the California company and the Nebraska company. The answer admits the allegation of paragraph 7 of the petition that the California company incurred a deficit of $28,100.66 in its operations during the year 1936. This deficit would have been greater without the local business in California. I believe 1936 was the first year we operated at a loss in California, the California corporation,—also 1932 and 1933. Profits were made in the remaining years. This is a photostatic copy of what we call the second,—what I called in my testimony a little while ago the second open account kept by the Nebraska company with the California company for the purpose of clearing the yearly profits and losses. It covers all the years of the California company's operations 1932 to 1938. That bears out my recollection that there was a loss for 1932.

[fol. 47] Counsel for Petitioner: I will offer that in evidence first.

The Member: Is there an objection?

Counsel for Respondent: No, your Honor, but I wish Mr. Clark would show from what company's books this comes.

Counsel for Petitioner: My question was meant to include it as a page of the account from the Nebraska company's ledger showing its open account—second open clearing account with the California company.

The Witness: It is.

Counsel for Respondent: Very well.

Counsel for Petitioner: I offer it in evidence.

Counsel for Respondent: No objection.

The Member: Received.

(Account sheet, received and marked Petitioner's Exhibit 3 in evidence.)

The loss for 1936 was handled on the—accounted for on the California books through open account with the Nebraska corporation and likewise accounted for on the Nebraska corporation's books through open account. I have before me the California company's books. On the Nebraska books we have a credit to the open account of Union Pacific Stages of California—net profit or deficit from operations. I will read into the record the entry for 1936 which appears in Exhibit 3. This is a photostatic copy of the account on the Nebraska corporation entitled Union Pacific Stages of California net profit or deficit from operation, and shows for the year 1936 an item credited for that account of $28,100.66, as of December 31, 1936. That entry represents the loss in the California corporation for the year 1936. The entry was made on the books of the Nebraska company because that is the only means we have in our accounting system to clear the item. It was made on account of the Interstate Transit Lines company agreement of February 8, 1932, whereby it absorbed the deficits. This account is wholly confined to absorption of profits and losses by the parent company of the profits and losses of the California company. In the years in which the California company suffered losses the Nebraska company absorbed the California company's losses through this account, and in the years in which the California company made profits the [fol. 48] Nebraska company absorbed those profits through this account, and this account represents no other trans-

actions than those profits or losses. This account represents the accounting under the absorption contract. This photostat, taken from page 23 of the general ledger of the Union Pacific Stages of California, the California corporation, is an account on the books of the California corporation to which the losses or profits of that corporation is set up in open account with the Nebraska corporation.

Mr. Mann: I will offer that photostat in evidence from page 23 of the general ledger of the California company.

Counsel for Respondent: No objection.

The Member: It will be received.

(Account sheet received and marked Petitioner's Exhibit 4 in evidence.)

For 1936 the account shows a debit item of $28,100.66. That item represents the loss for the year 1936 of the California corporation. That loss was so entered in this account because this is the account to which we go for the profits and losses of the California corporation as per the contracts and arrangements with the Nebraska corporation. Through this account the California company charged the Nebraska company with its losses and credited the Nebraska company with its profits, and that was done under the absorption agreement of February 8, 1932. There are no other entries in this account other than such charges and credits as I have just mentioned.

Cross-examination.

By Mr. Henry C. Clark (Counsel for Respondent):

Q. Mr. Hall, from what account did you take this item of $28,100.66 that is entered on the accounts you have just been looking at?

A. From the income account.

Q. Is this what you referred to, I am not sure?

The Member: What has the witness in his hand?

The Witness: This is a ledger account of the Nebraska corporation entitled "ledger account—Interstate Lines, Inc.—open account".

By Mr. Henry C. Clark:

Q. Are these the accounts that you referred to?

A. No, sir.

[fol. 49] Q. Well, what are those accounts that I just handed you?

A. One of them is the statement of the entries on the Nebraska corporation's books and ledger account, Union Pacific Stages of California—open account during the year 1936.

The other one is the detail of the monthly debits and credits made on the California books in the ledger account, Interstate Transit Lines—open account for the year 1936. They represent the same entries. They represent what was referred to on the direct examination as one of these open accounts, the open account other than the one that was limited to profit and loss.

Counsel for Respondent: We offer these, your Honor, as representing the other so-called open account that was referred to on direct examination.

Mr. Mann: No objection.

The Member: Let them be identified by the witness so that we may know what we are reading.

Counsel for Respondent: They may be offered jointly as one exhibit.

The Member: Received as Respondent's Exhibit A.

(2 sheets received [anr] marked Respondent's Exhibit A in evidence.)

This paper that you hand me is a copy of the balance sheet of the Union Pacific Stages of California as of December 31, 1936.

Counsel for Respondent: We offer that in evidence.

Mr. Mann: No objection.

The Member: Received as Respondent's Exhibit B.

(Balance sheet received and marked Respondent's Exhibit B in evidence.)

These papers that you now hand me are a statement showing for Interstate Transit Lines, Union Pacific Stages of California and Interstate Transit Lines, Inc., the operating revenues, operating expenses, income and profit and loss for 12 months ended December 31, 1936.

Counsel for Respondent: We offer this in evidence.

The Member: Received as Respondent's Exhibit C.

(Statement received and marked Respondent's Exhibit C in evidence.)

I obtained this item of $28,100.66 shown on the profit and loss open account from the income account of the California [fol. 50] corporation, that is, not any of the accounts that have been offered here. I have that account here. There would not be a corresponding account on the accounting records of the Nebraska company. The account to which I have just referred is the income account in the general ledger of the California company and those figures come from another book. That figure, $28,100.66, the loss for the year 1936, has a total shown in here which is the difference between the operating revenues and operating expenses for the year as reflected by this statement you have. That is Exhibit C. Exhibit B doesn't show the red and the black figures. In the photostatic copy the red and black figures can't be brought out. Balance sheet of the Union Pacific Stages of California as of December 31, 1936, which is the original document of which Exhibit B is a photostat, is the original document showing the red and black figures which are not reflected on the photostatic copy.

Note: A red ring was placed around the figures on the photostatic copies which are red on the original exhibit. In printing this red ring appears as a black circle.

The Witness: In answer to the question, these exhibits show that to December 31, 1936, that there is an accumulated profit on the books of the California company of $47,512.18. The figure for the period ending December 31, 1935, is $75,612.84.

Q. Now, that last figure represents money, does it not, in the bank account of the Nebraska Company?

A. Well, you could term it that for the simple reason that the Nebraska corporation in the first instance collected all the money.

Q. Is it not true that the accounting records of both the Nebraska company and the California company show that that amount was held for the account of the California company by the Nebraska company?

A. That the amount of money——

Q. That the $75,000 item that you just referred to was held by the Nebraska company for the account of the California company.

A. I would say so, as I said a while ago, due to the fact that the Nebraska company in the first instance collected the money.

Q. Again referring to Exhibits 3 and 4, which is this so-called operating account of profit and loss, is it not a fact [fol. 51] that that account is the only recognition which has been given between these companies of that profit and loss from year to year?

A. Yes, of the profit and loss figure.

Q. Has there ever been any final settlement between these two companies of any profit and loss as between themselves?

A. Settlement has been made through the open account.

Q. In other words, is it true that the only—that the most that has been done is the placing of these entries on the books of account?

A. Insofar as the profit and loss is concerned, yes.

Q. There has never been any cash settlement of any sort between the two companies, has there?

A. No, sir.

Q. And, as I understood your testimony, as of January 1, 1936, the California company's operations, according to the accounting which was kept, showed an aggregated profit of slightly over $75,000?

A. Yes.

Q. And if there be deducted from that this deficit of slightly over $28,000 for the year 1936, there would remain a profit balance at the end of 1936 of something over $47,000, would there not?

A. I believe that is the correct figure. It is correct on the balance sheet there.

Q. And nothing else was done between the companies except the entry of some figures on the books, was there, as to 1936?

A. No, sir, not with respect to the profit and loss item, no.

Q. Well, is this not true, that from the organization of the California company and its operation from year to year, through the year 1936, we find that because of the profit which it made during the early years that there always was shown on these records a profit balance in its favor?

A. For each and every year prior to 1935 I couldn't testify because I don't have the record here. However, the figure is accumulative profit and loss up to the period shown.

[fol. 52] Q. And these reports show that as of December 31, 1936, there was a profit balance remaining of over $47,000?

A. Yes, sir.

Q. So that, as a matter of fact, the Nebraska company was not called upon and did not in any manner advance to the California company the $28,000 item of so-called deficit for 1936?

A. No.

Referring to this Exhibit C which shows under the first block the revenue items and then a series of blocks of various sorts of expense items, the item of passenger revenue is not apportioned on the bus mile basis. Intrastate passenger revenue earned within the State of California is assigned to the California corporation and California's proportion of the interstate revenue is allocated to California on the basis of the number of miles travelled by the individual passengers. The interstate is apportioned. You have an item of rent from equipment in the operating revenues which is not apportioned on the mileage basis. That represents the use of other companies' equipment—the use of the California company's equipment on the properties of the other lines. The equipment rental which is shown here as being earned by the Nebraska company is the rent of Nebraska cars operated in California and Illinois territory. We keep an accurate accounting record of the mileage run by each bus for more reasons than one. There is no expense charge shown there for general office rent, the rent of the general offices in Omaha. Those offices are not in the office building of the railroad company in Omaha. The headquarters office of the bus line is owned by the Nebraska corporation. No rental apportioned is to either of the sub-companies. We use the railroad attorneys for convenience. If, in the operations of the Nebraska bus company we need legal advice, we go to the Legal Department of the railroad company and we are billed for that and pay the bills. The voucher or check is payable to the Union Pacific Railroad Company. Those bills are apportioned between the companies. We do not make any attempt to arrive at the income of the California company for passenger revenues, with the exception of the intrastate, other than by this mileage allocation basis. Those two items, partial checking and at the depots, I believe is assigned direct to the California corporation right there in the City of Los An- [fol. 53] geles. Now, looking at the expense items and taking first block one headed maintenance of building and grounds, those expense items are apportioned between the

companies insofar as there are any on the mileage basis. There don't happen to be any. Now, turning to block two, which is headed maintenance of equipment, those items are all allocated to the three companies on the proportionate mileage basis with the exception of the retirement items, and that is handled in conjunction with the accounting for depreciation.

Blocks three and four together, one being headed traffic expenditures and the other transportation expenses, are allocated between the three companies on a mileage basis. Under item 4, rent for equipment is not apportioned on a mileage basis.

Now block five, entitled general expenses, there are no items there which are not apportioned on the mileage basis between the companies.

We come to block six, depreciation. Depreciation is accrued on the books of the respective companies based on the depreciable property in the investment account and not apportioned on the mileage basis. In other words, each company is charged with the depreciation on that specific property which is found in its own individual investment account. What I referred to as depreciation accrual is what we term a charge to operating charge item. It is a deduction from operating item, crediting depreciation reserve.

An item here that stands in a line by itself just below this block six, the item to which I refer being entitled taxes. There is no apportionment between the companies on that item

Q. How is that item allocated between the companies?

A. Taxes assigned directly to the respective companies, accrued on the books.

Q. If the Nebraska company were to pay $2,500 as income taxes for the California company, then that would be charged directly to the California company, would it not, in that amount?

A. It would be charged on that account.

Q. And it would be charged here as a charge to the California company?

[fol. 54] A. As having been accrued on the California books.

Q. And would that item include whatever taxes might be paid to the several states, income, excess profits, capital

stock taxes or Social Security taxes paid to the Federal Government and any license taxes paid to the states?

A. Yes, sir, I might state it this way, that it includes all taxes which are paid for account of the California company by the Nebraska company. Put it that way.

Q. You referred in your direct testimony, Mr. Hall, to capital expenditures made by the Nebraska company for the account of the California company. What did you mean by that? Can you name some of those?

A. The reference there to capital expenditure, what I had in mind was the purchase of buses or shop machinery or any items which the California corporation capitalized. That is, they charged to capital investment account. The I. C. C. perhaps would call it additions and betterments, tangible assets.

Q. The purchase of tangible assets, that is what you really meant?

A. Such as cars.

Q. As a matter of fact you didn't undertake, I suppose now from what you have said, to classify any advances which the parent company might have made to itself, as not being a capital advance, did you?

A. Classified them as not being capital investment?

Q. Yes, you didn't mean to do that, did you?

A. No, sir.

Q. I will state another question. Has the Nebraska company at any time after the commencement of business of the California Company, found it necessary to advance to the California company a single dollar?

A. The Nebraska company has paid all of the bills of the account of the California company.

Q. Did it not pay those bills out of the revenues which it had previously received which properly belong to the California company.

A. In making payments, I doubt if it's possible to earmark a dollar for which payments are made.

Q. Isn't it true at the time revenues which the Nebraska company received during the entire time commencing with the beginning of the business of the California company and [fol. 55] continuing through the year 1936, that those revenues exceeded all disbursements which were made for the account of the California company?

A. I would say not.

Q. Will you tell us when that was not true?

A. The reason I state that is because in the beginning, in answer to your question, the California company started in 1932 and at the beginning the Nebraska corporation had to put up money to buy the two buses for the California company and it's a cinch that the California company hadn't any money at that time, hadn't accumulated or had been operating, so that the Nebraska corporation could not obtain any money from the operations in California, that is, a sufficient amount to cover the amount that they originally put up.

That is what I am getting at.

Q. Didn't the Nebraska company subscribe to all of the outstanding stock of the California company?

A. Yes.

Q. What did they give to that company?

A. It was in dollars and cents?

Q. Whatever it was.

A. That was handled through open account between the two companies.

Q. Well, as a matter of fact, didn't the Nebraska company receive that stock because of whatever contributions that it made to the California company, either in cash or by furnishing equipment at the time the California company started business?

A. They paid for the stock through open account and also the investment that the California company originally acquired was handled through open account on the books of each company.

Q. And was there any balance, one way or the other, after the stock account was completed? Did the California company owe the Nebraska company or did the Nebraska company owe the California company? I am speaking back to when the stock was issued.

A. Well, as I say, the Nebraska corporation, the acquisition of the California company stock, made entries on their books through open account for the so-called purchase of the stock.

[fol. 56] Likewise, California did the same thing in getting their stock issued.

Q. And they balanced one another, the stock against the advance?

A. Of course, in the beginning, in addition to the open account for the stock, Interstate Transit Lines also paid

for the physical assets of the California corporation which was in excess of the amount of stock issued.

Q. But, as I understand you, as of December 31, 1935, the Nebraska company was $75,000 to the good as shown by its books and the books of the California company because of the operations of the California company?

A. Yes, I believe that is the figure shown on the balance sheet, as I recall it.

Q. And at the end of 1936, all that was done was to reduce that balance by the amount of this so-called $28,000 deficit, is that true?

A. Yes, insofar as the profit and loss account is concerned, that is true.

Q. Well, is there any way in which it is not true?

A. No, sir, because it was the profit and loss account we are speaking of.

Q. So that at the end of 1936, we find that the Nebraska company is still $47,000 to the good, because of the operation of the California company as shown by the books, is that correct?

A. Not considering the open account, yes.

Q. What do you mean the open account? You mean this Exhibit A?

A. Yes, sir.

Q. All right, you say not considering it. What would it be if you do consider it?

A. At the end of December, 1936, the books of the California corporation show liability brought about by the aggregate of the open account and the net profits per operations of $5,874.96.

Q. A liability to whom?

A. To the Nebraska corporation.

Q. Well, now, what gave rise to that difference? In other words, why is not the $47,000 item shown on the open account of profit and loss correct? Why do you now modify it to that $5,000 item?

[fol. 57] A. That is the correct figure for the net profit from operations to December 31, 1936, but as I understood you to say that it be to the good, the Nebraska corporation would be to the good of that particular figure, I would say that the Nebraska corporation would not be to the good of that particular figure.

Q. And why?

A. For the simple reason, as I mentioned there, it takes the open account through which the current items are handled and the net profit from operations together making a net liability on the part of the California company.

Q. Well, is that open account, this item Exhibit A?

A. Yes, sir.

Q. What is there to cut down that $47,000 item that represents what the Nebraska company is supposed to have been entitled to for the period up through 1936? What is there on this other open account item to cut that down?

A. Well, it's through that open account item, the first one, this one here (indicating), it's through the account Interstate Transit Lines—open account, that the open account entries are made on the California books.

The Member: And the open account to which you just referred, is that shown on Exhibit 4?

The Witness: Yes, sir.

Q. Mr. Hall, am I correct in understanding you then to say that in the first place, the Nebraska company, as shown by the profit and loss open account, was $47,000 to the good as of December 31, 1936?

A. That is right, the net profit from operations December 31, 1936, on the California books shows a profit as of December 31, 1936, of $47,512.18.

Q. You referred to another open account item which, as I understand you, is in the sum of $41,637.23, is that right?

A. That is right.

Q. And as I would understand you, by your looking at Exhibit B, this balance sheet, I would say that the last-mentioned item of $41,000 odd is to be subtracted from forty-seven thousand odd dollars item?

A. That is correct.

[fol. 58] Q. And that would leave then under any conditions, that Nebraska corporation, at the end of 1936 was to the good, $5,874.96, is that correct?

A. Yes, sir.

Q. And there is no exception to that, is there?

A. No, sir.

Q. Aside from the commencement of the California company business, in getting it going, did the Nebraska company ever advance a dollar to the California company?

A. Well, as I have testified before, the Nebraska corporation paid all the bills, paid all necessary expenses for investment, that is, buses, rents, taxes or what have you.

Q. But it paid them out of revenues, did it not, after the business got going?

A. Well, as I say, I think that that would be very hard to testify, due to the fact that the dollars are not earmarked.

Q. Did the Nebraska company pay any dividends?

A. The Nebraska company?

Q. Yes.

A. Certainly.

Q. Did it pay dividends each year down through 1936?

A. No, sir, you mean from commencement of the corporation?

Q. Yes.

A. It did not.

Q. Did it pay dividends in 1936?

A. Yes, sir.

Q. How about 1935?

A. Yes, sir.

Q. 1934?

A. Yes, sir.

Q. 1933?

A. No, sir.

Q. 1932?

A. No, sir.

Counsel for Respondent: That will be all.

Redirect examination:

There has been some question about settlement of the two companies through inter-open accounts. Exhibit 4 shows [fol. 59] that on the dissolution of the California company there was a final settlement between the Nebraska corporation and the California corporation in 1940. That was in connection with the dissolution of the subsidiary company. The balance sheet of the California company at November 30, 1936, shows that at that date on the two open accounts, the California company owed to the Nebraska company seventy-five odd thousand dollars as a result of the completion of profit and loss settlements for prior years and at the same time, shows an indebtedness from the Nebraska company to the California company of $41,000 on account of

open current account—cash open account, so that there was at that date a balance owed by the California company to the Nebraska company of $34,124. In the open account on the Nebraska company's books with the California company, Exhibit A, the December items in that account show that the charges and debits to the cash open account in the month of December are both about $17,000, so the open account varied less than a thousand dollars during the month of December. At the time I made the entry in Exhibit 4 on December 31, 1936, recording the $28,100.66 loss of the California corporation, there was a balance owed by the California corporation to the Nebraska corporation of approximately $34,000. So the effect of the entry which I made in Exhibit 4 of $28,100.66 was to reduce the balance owed by the California corporation to the Nebraska corporation by $28,100, and still left a balance owed by the California corporation to the Nebraska corporation of $5,000. The California corporation had no bank account. The Nebraska corporation was its banker. There was no other way about which I am aware that the settlement between the two corporations could have been made other than by charging that open account.

Re-Cross Examination

There was never any final settlement between these companies prior to 1940, when the California company was dissolved.

[fol. 60] The limited stipulation of facts was submitted which the Member ordered to be filed and become a part of the record. The stipulation follows.

Dated January 7, 1942.

Henry W. Clark, Attorney for Plaintiff.

Nelson Trottman, Of Counsel.

Approval of Statement of Evidence

No objection to the foregoing statement of evidence.

J. P. Wenchel, Atty. for Respondent.

Approved and Ordered Filed this 4-Day of February, 1942.

J. Russell Leech, Member.

STIPULATION OF FACTS

It is hereby stipulated and agreed by and between the petitioner and the respondent, by their respective attorneys of record, that the following facts and statutory provisions may be considered as true and correct in deciding the issues involved in the above proceeding; each party reserving the right to introduce other and further evidence not inconsistent herewith.

(1) Petitioner was incorporated in 1928 under the laws of the State of Nebraska.

(2) Union Pacific Stages of California was incorporated in 1930 under the laws of the State of California.

(3) During the period from 1927 through the year 1936, California Statutes in their Public Utilities Act, Sec. 50-1/4, 1927 Statutes, page 74; Deering's General Laws of California, 1937 Edition, Act 6386, page 3161, provided as follows:

[fol. 61] "No passenger stage corporation shall hereafter operate or cause to be operated any passenger stage over any public highway in this state without first having obtained from the railroad commission a certificate declaring that public convenience and necessity require such operation, but no such certificate shall be required of any passenger stage corporation as to the fixed termini between which, or the route over which, it is actually operating in good faith at the time this act becomes effective in compliance with the provisions of an act known as Chapter 213, Statutes of 1917 of the State of California, approved May 10, 1917, and amendments thereto, nor shall any such certificate be required of any person or corporation who on January 1, 1927, was operating, or during the year 1926 had operated a seasonal service of not less than three consecutive months duration, sightseeing buses on a continuous sightseeing trip with one terminus only."

Dated, New York, N. Y., January 16, 1941.

Henry W. Clark, Counsel for Petitioner; J. P. Wenchel, Counsel for Respondent.

PETITIONER'S EXHIBIT 1

This Agreement, made as of the seventh day of February, 1932, by and between Interstate Transit Lines, a corporation organized and existing under the laws of the State of Nebraska, (hereinafter called Transit Lines), party of the first part, and Union Pacific Stages of California, a corporation organized and existing under the laws of the State of California, (hereinafter called the California Corporation), party of the second part, Witnesseth:

Recitals: The California Corporation is a subsidiary of, and all of its capital stock is owned by, Transit Lines. Transit Lines operates busses between various points but operates no busses in the State of California. The California Corporation operates busses in the State of Cali- [fol. 62] fornia. The California Corporation is maintained as an operating subsidiary of Transit Lines and its operations are conducted solely for the benefit of Transit Lines. In order that Transit Lines may obtain the greatest benefit from the operations of the California Corporation it is necessary that the schedules of the California Corporation be coordinated with the schedules of Transit Lines, and that the California Corporation operate on such routes and upon such schedules as will most greatly benefit Transit Lines. Since such operation may not be so remunerative to the California Corporation as operation solely for its own corporate benefit, the parties hereto have agreed that during the term of this agreement such coordinated bus operation shall be carried on under the terms and conditions hereinafter set out.

Now, Therefore, the parties hereto mutually agree as follows:

First: The California Corporation agrees to operate busses upon such routes and upon such schedules, and under such operating rules and regulations, as may be directed by Transit Lines.

Second: Transit Lines agrees to assume and to reimburse the California Corporation for any deficits incurred by the California Corporation in its operations. The California Corporation agrees to pay over to Transit Lines any profits resulting to the California Corporation from its operations. Payments hereunder shall be made only at the end of each

calendar year. The deficit or profit, however, shall be calculated for each calendar month separately.

Third: This agreement shall be effective as of the seventh day of February, 1932, and shall continue in full force and effect until terminated by notice as herein provided. Either party hereto may terminate this agreement on the last day of any calendar month by notice delivered on or before that day to the other party hereto.

In Witness Whereof, the parties hereto have caused this agreement to be executed by their respective officers there- [fol. 63] unto duly authorized, and under their respective corporate seals as of the date first above written.

Interstate Transit Lines, By R. J. Walsh, President.

Witness: A. C. Phillips.
Attest: C. B. Matthai, Secretary.

Union Pacific Stages of California, By R. J. Walsh, President.

Witness: A. C. Phillips.
Attest: C. B. Matthai, Secretary.

PETITIONER'S EXHIBIT 2

This Agreement, made and entered into this eighth day of February, 1932, by and between Interstate Transit Lines, a corporation of the State of Nebraska (hereinafter called "Transit Company"), party of the first part, and Union Pacific Stages of California, a corporation of the State of California (hereinafter called "Stage Company"), party of the second part, Witnesseth:

Recitals: The Transit Company has been operating a passenger motor coach transportation business from points east of Salt Lake City, Utah, through Salt Lake City and Las Vegas, Nevada, to Los Angeles, California, doing only an interstate business in the State of California. The Stage Company, a subsidiary of the Transit Company, contemplates engaging in certain intrastate motor coach operations in the latter state and it has been arranged between the parties hereto that the Stage Company, in addition to performing said intrastate operations, will take over as suc-

[fol. 64] cessor of the Transit Company all motor coach operations heretofore performed by the Transit Company in the State of California. The Transit Company will therefore terminate its motor coach operations at the California-Nevada State line and there connect with the motor coach lines of the Stage Company. For convenience and economy of operation, it is desirable that the buses of each party run through from its territory into the territory of the other party.

Agreement:

Now, Therefore, it is mutually agreed by and between the parties hereto as follows:

Section 1. The buses of the Transit Company operating from points north of the California-Nevada State Line shall on each trip continue through south of said State line, and at said State line shall pass into the custody and possession of the Stage Company. The buses of the Stage Company operating from points south of said State line shall continue through north of said State line, and shall pass into the custody and possession of the Transit Company at said State line. Each party shall during the term of this agreement, and hereby does, lease its buses to the other party while so in the custody and possession of such other party, subject to the terms and conditions hereinafter stated.

Section 2. The owning party is hereinafter for convenience designated as the "Lessor" and the party to which said buses are hereby leased is hereinafter designated as the "Lessee". The Lessee shall pay to the Lessor monthly a sum of money equal to Five Cents (5c) for each and every mile run by each bus of the Lessor while in the custody and possession of the Lessee. The Lessee shall bear and pay that portion of the expense of maintaining and operating said buses (other than drivers' wages and taxes) and of insurance thereon, including fire, public liability and property damage, which is properly attributable to said buses while in its possession. The drivers of the buses involved in this agreement shall be the sole employes of, and their wages shall be paid by, the Lessee while such drivers are in service in connection with leased buses in the custody [fols. 65-66] and possession of the Lessee. Each party shall pay taxes on its own buses. Adjustments of accounts as

between the parties hereto shall be made monthly as soon after the first of each month as practicable.

Section 3. The Lessee shall be responsible to the Lessor for the buses of the Lessor while in the Lessee's custody and possession.

Section 4. This agreement shall take effect on the date first herein written and shall continue in full force and effect until terminated by written notice given by either party hereto to the other on any date in such notice stated not less, however, than thirty (30) days subsequent to the date on which such notice shall be given.

In Witness Whereof, the parties hereto have caused this agreement to be executed in duplicate as of the date first herein written.

Interstate Transit Lines, by R. J. Walsh, President.

Witness: John A. Bennewitz. (Seal.)
Attest: C. B. Matthai, Secretary, ITL.

Union Pacific Stages of California, by R. J. Walsh, President.

Witness: John A. Bennewitz. (Seal.)
Attest: C. B. Matthai, Secretary, UPSOC.

Approved as to form: John A. Bennewitz, General Attorney.

Record.

[redacted]

					Dec 31	8	28100 00
		7	2	5 7 5 21	31	Balo	
			3	1 0 4			
		196					
		187	20	8 4 1 64			
Dec 31		8					
			75	6 1 2 85			75 6 1 2 85
1937					1937		
Jan 1	Balance		47	3 2 18	Dec 31	4	29 6 2 3 14
							17811 71
			47	3 1 2 1			
1938					1938		
Jan 1	Balance			1 1 1 04			
		10		1 6 1 2 00		Balance	30 19090
			36	70 77			36 570 77
Dec 31, 1938	Balance		30	19090			

Dec	31		3	38	1	6	6		
	31	Balance		47	5	1	8		
				75	6	2	5	4	
1937									
Dec	31		3	29	6	2	3	17	
	31	Balance		17	8	8	8	99	
				47	5	1	2	18	
1938									
Jan	31		5	2	7	4	6	22	
Feb	1	Dissolution	1	32	7	8	2	79	
				35	7	2	9	01	

Dec	31								
	31	Balance		47	5	1	2	18	
				47	5	1	2	18	
1937									
Jan	1	Balance		47	5	1	2	18	

INTERSTATE TRANSIT LINES vs. COMMISSIONER - Docket No. 101692

RESPONDENT'S EXHIBIT "A"
INTERSTATE TRANSIT LINES

Ledger Account - Union Pacific Stages of California - Open Account Nos. 140-210

Date 1936		Folio	Debit	Date 1936			Folio	Credit
Jan. 31	Bus Rental	189	4 338.60	Jan. 1		Balance		67 843.12
" 31	Operating Expenses	190	10 033.16	"	31	Bus Rental	189	1 046.09
" 31	Taxes	190	3 440.40	"	31	Operating Revenues	190	11 175.65
Feb. 29	Bus Rental	194	3 470.08	Feb.	29	Bus Rental	195	1 029.80
" 29	Operating Expenses	196	9 819.09	"	29	Operating Revenues	196	8 028.11
" 29	Taxes	196	348.37	Mar.	31	Bus Rental	199	340.44
Mar. 31	Bus Rental	197	4 071.86	"	31	Operating Revenues	201	10 376.44
" 31	Operating Expenses	201	10 006.01	"	31	Operating Expenses-Adjustment	201	398.63
" 31	Taxes	201	3 371.37	Apr.	30	Bus Rental	203	885.20
Apr. 30	Bus Rental	203	4 810.48	"	30	Operating Revenues	206	11 871.57
" 30	Operating Expenses	206	9 740.70	May	31	Operating Revenues	4	14 013.48
" 30	Taxes	206	777.08	"	31	Bus Rental	6	719.78
" 31	Additional Federal Income Tax 1933	2	336.80	June	30	Bus Rental	4	1 126.04
" 31	Operating Expenses	4	10 361.52	"	30	Operating Revenues	6	19 238.38
" 30	Taxes	4	328.00	July	31	Bus Rental	1	1 442.72
" 31	Bus Rental	6	5 563.48	"	31	Operating Revenues	2	19 315.97
" 31	Bus Rental	4	6 800.96	"	31	Rebate Corp. Income Tax 1934	7	136.80

Date 1936			Folio	Debit
Jan.	31	Due Rental	189	4 339.60
"	31	Operating Expenses	190	10 033.16
"	31	Taxes	190	3 440.40
Feb.	29	Due Rental	194	3 470.08
"	29	Operating Expenses	196	9 819.09
"	29	Taxes	196	348.37
Mar.	31	Due Rental	197	4 071.86
"	31	Operating Expenses	201	10 006.01
"	31	Taxes	201	2 371.37
Apr.	30	Due Rental	203	4 210.48
"	30	Operating Expenses	206	9 740.70
"	30	Taxes	206	777.08
"	31	Additional Federal Income Tax 1935	2	336.80
"	31	Operating Expenses	4	10 381.82
"	31	Taxes	4	339.00
"	31	Due Rental	6	5 563.48
"	31	Due Rental	4	6 800.96
"	31	Operating Expenses	6	13 961.96
"	31	Taxes	6	1 019.13
"	31	Due Rental	7	.60
"	31	Due Rental	1	6 442.61
"	31	Operating Expenses	2	12 833.97
"	31	Taxes	3	1 382.96
"	31	Operating Expenses	1	14 518.14
"	31	Taxes	1	896.60
"	31	Due Rental	7	7 311.57
"	31	Due Rental	3	6 410.68
"	31	Operating Expenses	5	12 106.65
"	31	Taxes	5	1 478.58
"	31	Due Rental	1	4 640.49
"	31	Operating Expenses	4	9 766.32
"	31	Taxes	4	536.07
Nov.	30	Due Rental	1	4 296.99
"	30	Operating Expenses	1	9 307.70
"	30	Taxes	2	496.94
Dec.	31	Due Rental	1	5 278.58
"	31	Operating Expenses	1	10 448.81
"	31	Taxes	2	1 618.73
"	31	Balance		41 637.22
				251 444.15

Date 1936			Folio	Credit
Jan.	1	Balance	67	843.12
"	31	Due Rental	189	1 046.09
"	31	Operating Revenues	190	11 178.66
Feb.	29	Due Rental	196	1 028.80
"	29	Operating Revenues	196	8 038.11
Mar.	31	Due Rental	199	840.44
"	31	Operating Revenues	201	10 376.44
"	31	Operating Expenses-Adjustment	201	599.63
Apr.	30	Due Rental	203	865.20
"	30	Operating Revenues	206	13 871.67
May	31	Operating Revenues	4	14 013.48
"	31	Due Rental	6	719.78
June	30	Due Rental	4	1 126.04
"	30	Operating Revenues	6	19 235.38
July	31	Due Rental	1	1 442.72
"	31	Operating Revenues	2	19 315.97
"	31	Rebate Corp. Income Tax 1934	7	135.80
Aug.	31	Operating Revenues	1	20 530.16
"	31	Due Rental	7	807.36
Sept.	30	Due Rental	3	999.80
"	30	Operating Revenues	5	17 787.59
Oct.	31	Due Rental	1	1 328.14
"	31	Operating Revenues	2	13 560.19
Nov.	30	Due Rental	1	982.28
"	30	Operating Revenues	2	9 686.43
Dec.	31	Due Rental	1	1 310.34
"	31	Operating Revenues	2	16 296.93
				251 444.15

1937
Jan. 1 Balance 41 637.22

INTERSTATE TRANSIT LINES
vs. COMMISSIONER-Docket
101602-REPORT'S
EXHIBIT "A" - (Page 2)

UNION PACIFIC STAGES OF CALIFORNIA

Ledger Account Interstate Transit Lines - Open Account No. 83

			Debit	Credit					Debit	Credit
[illegible]		[illegible]		[illegible]	Jan.	31	Bus Rental		73	4 328.60
Jan.	31	Bus Rental	3	1 346.05	"	31	Operating Expenses		73	10 083.16
"	31	Operating Revenues	73	11 [illegible]	"	31	Taxes		74	3 440.40
Feb.	28	Operating Revenues	74	8 603.11	Feb.	28	Operating Expenses		74	9 818.09
	28	Bus Rental	75	1 302.10	"	28	Taxes		75	348.37
Mar.	31	Bus Rental	76	340.41	"	31	Bus Rental		76	3 470.06
"	31	Operating Revenues	76	10 376.44	Mar.	31	Bus Rental		76	4 071.56
"	31	Operating Expenses Adjustment	77	299.63	"	31	Operating Expenses		76	10 006.01
[illegible]	30	Bus Rental	78	565.30	"	31	Taxes		77	2 371.37
"	30	Operating Revenues	78	11 271.57	Apr.	30	Bus Rental		78	4 210.45
May	31	Operating Revenues	1	[illegible]	"	30	Operating Expenses		78	9 740.70
"	31	Bus Rental	2	765.75	"	30	Taxes		79	777.03
[illegible]	30	Operating Revenues	1	[illegible]	May	31	Operating Expenses		1	10 381.89
"	30	Bus Rental	2	1 120.04	"	31	Taxes		2	330.09
[illegible]	[illegible]	Operating Revenues	1	15 [illegible]	"	31	Bus Rental		2	5 563.48
	31	Bus Rental	2	4 [illegible]	"	31	Additional Federal Income Tax 1953		2	336.80
"	31	Rebate Corp. Income								

		Folio		Date 1938			Folio	Credit
	[illegible]		[illegible]	Jan.	31	Bus Rental	73	4 220.60
Jan.	31	Bus Rental	3		31	Operating Expenses	73	10 083.16
"	31	Operating Revenues	73		31	Taxes	74	3 440.40
Feb.	28	Operating Revenues	74	Feb.	28	Operating Expenses	74	9 818.09
	28	Bus Rental	73		28	Taxes	75	348.37
Mar.	31	Bus Rental	75		28	Bus Rental	75	3 470.08
"	31	Operating Revenues	75	Mar.	31	Bus Rental	75	4 071.96
"	31	Operating Expenses Adjustment	77	"	31	Operating Expenses	75	10 006.01
	30	Bus Rental	75	"	31	Taxes	77	2 371.37
"	30	Operating Revenues	77	Apr.	30	Bus Rental	78	4 210.45
May	31	Operating Revenues	1	"	30	Operating Expenses	78	9 740.70
	31	Bus Rental	2	"	30	Taxes	79	777.03
	30	Operating Revenues	1	May	31	Operating Expenses	1	10 281.89
"	30	Bus Rental	2	"	31	Taxes	2	330.09
	30	Operating Revenues	1	"	31	Bus Rental	2	5 563.48
	31	Bus Rental	2	"	31	Additional Federal Income Tax 1933	2	336.80
"	31	Rebate Corp. Income Tax 1934	2	June	30	Operating Expenses	1	12 961.96
	30	Operating Revenues	1	"	30	Taxes	2	1 019.13
	30	Bus Rental	2	"	30	Bus Rental	2	6 800.96
	30	Operating Revenues	1	"	30	Bus Rental	3	.60
	30	Bus Rental	2	July	31	Operating Expenses	1	12 823.97
	31	Operating Revenues	1	"	31	Taxes	2	1 382.96
	31	Bus Rental	2	"	31	Bus Rental	2	5 442.61
	30	Operating Revenues	1	Aug.	31	Operating Expenses	1	14 518.14
	30	Bus Rental	2	"	31	Taxes	2	596.60
	[illegible]	Operating Revenues	[illegible]	"	31	Bus Rental	2	7 311.87
	[illegible]	Bus Rental	[illegible]	Sept.	30	Operating Expenses	1	12 106.65
				"	30	Taxes	2	1 479.58
				"	30	Bus Rental	2	6 410.68
				Oct.	31	Operating Expenses	1	9 766.32
				"	31	Taxes	2	536.07
				"	1	Bus Rental	2	3 540.49
				[illegible]	30	Operating Expenses	[illegible]	[illegible]
					30	Taxes	[illegible]	[illegible]
					[illegible]	Bus Rental	[illegible]	[illegible]
				[illegible]	[illegible]	[illegible] Expenses	1	10 [illegible]
					[illegible]	Taxes	[illegible]	1 [illegible]
					[illegible]	Bus Rental	[illegible]	5 279.[illegible]
					[illegible]	Balance		41 537.34
								351 444.15

[redacted] Final

FORM 4.

UNITED PATENTS [illegible]

INCOME AND PROFIT AND LOSS

December 31, 1956

ACCOUNTS				
ASSETS				
121 PROPERTY [illegible]				
Motor Coaches			25 471.26	
Office and [illegible] Equipment			2 [illegible]	
Machinery, [illegible] Equipment			3 [illegible]	
Franchises			11 [illegible]	
Improvements [illegible]			2 [illegible]	44 331.26
Total Assets				44 331.26
LIABILITIES				
[illegible] CAPITAL				25 000.00
[illegible] ACCRUED [illegible]				
Interstate [illegible]			41 637.22	
Interstate [illegible]				
[illegible]	26		97 312.18	5 674.96
TAX LIABILITY				
[illegible]				
Less: State [illegible]				
State and County Taxes [illegible]	36		11 [illegible]	
Less: State and County Taxes Paid for		36	11 [illegible]	
State and County Taxes Paid [illegible]	37		15.00	
Federal [illegible]				
Less: Federal Income Tax [illegible]				
Federal Income Tax [illegible]				
Less: Federal Income Tax [illegible]				
Federal Capital [illegible]				
Less: Federal Capital [illegible]				
Federal Capital [illegible]		34	[illegible]	
Less: Federal [illegible]		34	[illegible]	
Federal Miscellaneous [illegible]				
Less: Federal [illegible] Paid				
19				

TAX LIABILITY				
State and County Taxes Estimated				
Less: State and County Taxes Paid in Excess				
State and County Taxes Estimated for Year	36		11 [illegible]	
Less: State and County Taxes Paid for		36	11 [illegible]	
State and County Taxes Paid in Advance	37		15.00	
Federal Income Tax Estimated				
Less: Federal Income Tax Paid				
Federal Income Tax Liability				
Less: Federal Income Tax Paid				
Federal Capital Stock Tax Estimated				
Less: Federal Capital Stock Tax Paid				
Federal Capital Stock Tax Liability				
Less: Federal Capital Stock Tax Paid	34		[illegible]	
Federal Miscellaneous Taxes		34	109.97	
Less: Federal [illegible] Paid				
19__				
Federal Excise Tax under Tax Act, Schedule [illegible]	36		84.29	
Less: Federal [illegible] Security Act, Paid in Excess				
TOTAL LIABILITIES				136.26
Motor Vehicles			8 691.68	
Office and [illegible] Equipment			1 109.01	
Machinery, Tools and [illegible]			1 [illegible].14	
Improvements on Leased Property			2 [illegible].44	13 617.27
[illegible]				44 [illegible].04
[illegible]				
INCOME ACCOUNT				
Operating [illegible]				
Net Operating [illegible]				183 [illegible].60
Taxes			199 [illegible].98	
Miscellaneous Income			12 097.61	
Total Income [illegible]				4.13
Deficit for Twelve Months Ended December 31,		36	211 470.10	183 [illegible].73
				28 [illegible].26
PROFIT AND LOSS ACCOUNT				
[illegible] Balance Transferred from Income Account				
[illegible] Months Ended December 31,		36	28 100.64	
Profit and Loss Distributed [illegible]				
Total Profit and Loss Account			28 [illegible].64	28 100.64
				28 [illegible].64

Chem. Engr., January 20, 37

Form 914 (First Sheet)

[redacted]

INTERSTATE TRANSIT LINES
UNION PACIFIC STAGES OF CALIFORNIA
INTERSTATE TRANSIT LINES, INC.

OPERATING REVENUES, OPERATING EXPENSES, INCOME, AND PROFIT AND LOSS.

FOR Twelve Months Ended December 31, 1936

ACCOUNTS	Union Pacific Stages of California	Interstate Transit Lines Inc.	Interstate Transit Lines	This Year Amount	This Year Inc. or Dec. Red	This Year Per Cent
OPERATING REVENUES						
1. Freight Revenue	161 187.32	26[illegible]	3047 358.98	3471 [illegible]	[illegible]	4.37
2. Passenger Revenue	[illegible]	346.78	3 923.9[illegible]	4 [illegible]	1 [illegible]	42.65
3. Excess Baggage Revenue			326 [illegible]	[illegible]	7 [illegible]	1.90
4. Mail Revenue	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
5. Package Revenue	2 117.15	[illegible]	16 395.04	1[illegible]	[illegible]	[illegible]
6. Other Passenger Service Revenue	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
7. Charter Service Revenue	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
8. Revenue Received from Railroads under Contract	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
9. Commissions from Ticket Sales	082.83	[illegible]	[illegible]	61 985	[illegible]	1.14
10. Parcel Checking and Storage Revenue	377 30	[illegible]	12 593 67	[illegible]	[illegible]	[illegible]
11. Station, Bus and Garage Concessions	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	33.49
12. Rent from Buildings and Other Property			[illegible]	[illegible]	232 87	6.00
13. Rent from Equipment	12 073 76	53 248 27	149 941.37	231 263 [illegible]	[illegible]	5.20
14. Miscellaneous Revenue	5 00	14.64	3 517 30	[illegible]	[illegible]	7 53
Total Operating Revenues	183 365.60	341 983 76	3472 494.59	[illegible]	[illegible]	2 89
OPERATING EXPENSES:						
I. MAINTENANCE OF BUILDINGS AND GROUNDS						
15-1. Salaries of Officers						
15-2. Salaries of Clerks and Attendants	-	-				-
15-3. Office Rents						
15-4. Traveling and Office Expenses	-	-			-	-
Total Superintendence	-	-	-			-
16. Repairs to Garage and Shop Buildings	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	19 85
17. Repairs to Bus Depots and Terminal Buildings	255 60	[illegible]	4 525 [illegible]	[illegible]	[illegible]	1 14
18-1. Retirements—Buildings						-
18-2. Retirements—Office and Agency Equipment	-	-	-		[illegible]	-
18-3. Retirements—Miscellaneous		-			-	
Total Retirements	-	-	-	-	[illegible]	-
19. Other Maintenance Expenses		-	-	-	-	
Total Maintenance of Buildings and Grounds	819.70	[illegible]	[illegible]	[illegible]	800.80	[illegible]

II. MAINTENANCE OF EQUIPMENT						
25-1. Salaries of Officers					.12.30	-
25-2. Salaries of Clerks and Attendants	35[illegible]	567 71	[illegible]	[illegible]	334.38	5.51
25-3. Office Rents	-	-	-	-	-	-
25-4. Traveling and Office Expenses	18.[illegible]	28.30	322.42	369.09	[illegible]	10.95
Total Superintendence	354.75	596.01	[illegible]	[illegible]	359.61	[illegible]
26. Repairs to Machinery, Tools and Equipment	350.49	405.01	4 583.25	5 [illegible]	[illegible]	[illegible]
27-1. Tires and Tubes	6 839 34	10 811.39	118 711.62	137 162.35	[illegible]	34
27-2. Wages of Shopmen	7 861 81	12 149.05	137 519 40	157 510 26	[illegible]	2.60
27-3. Car Repair Materials, Supplies and Expenses	7 [illegible]13.77	11 8[illegible]1.74	133 392 52	152 818 03	[illegible]03.47	2.12
27-4. Shop Expenses	682.[illegible]	1 050.78	11 340.50	13 673 31	1 092 33	7.40
27-5. Outside Repairs to Cars	411.54	634.18	7 131 14	8 236 [illegible]	[illegible]05.92	11 82
Total Repairs to Motor Coaches and Buses	23 388.49	36 257 14	409 755.18	469 4[illegible]	[illegible] 177.59	2.12
28-1. Tires and Tubes	58 8[illegible]	91.89	1 036 34	1 [illegible]	251.22	26 84
28-2. Wages of Shopmen	-	-	-	-	-	-
28-3. Car Repair Materials, Supplies and Expenses	93.98	142.33	[illegible] 625.51	1 860 82	570.91	14.86
28-4. Shop Expenses	-	-	-	-	-	-
28-5. Outside Repairs to Cars	28.42	44.72	499.94	573.08	26.42	4.83
Total Repairs to Trucks, Automobiles and Tractors	180.26	278.94	3 161.79	3 620.99	848.54	30.61
29-1. Retirements—Motor Coaches and Buses	-	-	[illegible]	3 508.31	60 756.42	91.87
29-2. Retirements—Trucks, Automobiles and Tractors			[illegible]	456.00	579.96	61 [illegible]
29-3. Retirements—Machinery, Tools and Equipment				-	-	-
Total Retirements	-	-	3 [illegible]	3 964.41	61 336.38	91.25
30. Injuries to Persons	128.31	132.62	2 160.72	2 461.05	1 529.65	-
31. Other Maintenance Expenses	711.22	478.61	5 [illegible]	6 167.95	1 551.87	33.60
Total Maintenance of Equipment	24 653.[illegible]	38 227.35	427 805.59	495 687.00	36 754.99	7.62
III. TRAFFIC EXPENSES						
35-1. Salaries of Officers	265 44	411.58	4 665.18	5 [illegible] 40	352 80	7.07
35-2. Salaries of Clerks and Attendants	2 379 68	3 685.96	41 [illegible] 71	47 [illegible] 35	5 220.47	12 24
35-3. Office Rents	43.43	67.87	758 90	[illegible]	[illegible]20.00	41.33
35-4. Traveling and Office Expenses	[illegible] 21	[illegible] 42	17 148.99	19 638.78	2 137.33	12.22
Total Superintendence and Solicitation	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
36. Advertising	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
37. Other Traffic Expenses	53 13	[illegible] 28	346.53	[illegible] 084.56	1 [illegible]4.30	63.35
Total Traffic Expenses	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
IV. TRANSPORTATION EXPENSES						
40-1. Salaries of Officers	1 634 73	2 529.23	28 626.34	32 790.00	2 [illegible]	[illegible] 35
40-2. Salaries of Clerks and Attendants	777 80	1 204.71	13 649 35	[illegible]	1 [illegible]	[illegible].03
40-3. Office Rents				-		
40-4. Traveling and Office Expenses	322.[illegible]4	[illegible]	5 [illegible]	[illegible] 42[illegible]	1 [illegible]	[illegible]
40-5. Operation of Business Cars	[illegible]. 21	[illegible]	[illegible] 29	2 539 83	[illegible]	[illegible]
Total Superintendence	2 [illegible]	[illegible]	49 [illegible]	56 [illegible]	[illegible]	[illegible]

[fols. 79-80] 57

Form 914 (Second Sheet)

INTERSTATE TRANSIT LINES
UNION PACIFIC STAGES OF CALIFORNIA
INTERSTATE TRANSIT LINES, INC.

[redacted]

OPERATING REVENUES, OPERATING EXPENSES, INCOME, AND PROFIT AND LOSS.

FOR [illegible] months Ended December 31 1936

ACCOUNTS	Union Pacific Stages of California	Interstate Transit Lines Inc.	Interstate Transit Lines	This Year Amount	This Year Increase or Decrease	This Year Per Cent
IV. TRANSPORTATION EXPENSES (Continued)						
41-1 Salaries of Station Employes	6 819 33	10 554.42	119 401.95	136 875.60	8 008.36	6.21
41-2 Commissions Paid Agents	[illegible].44	18 543.44	208 323.55	238 802.33	12 866.04	5.10
42-1 Rent for Stations	[illegible]	10 [illegible] 79	117 731.95	134 [illegible].76	13 786.70	11.35
42-2 Other Station Expenses	1 [illegible].45	2 [illegible]	28 092.35	32 871.44	381.02	2.02
Total Station Expenses	[illegible]	41 [illegible]	471 647.90	540 378.95	9 544.54	1.80
43 Rent for Equipment	[illegible]	74 237.65	102 [illegible]	239 637.81	12 353.82	5.44
44 Wages of Drivers	[illegible]	39 872.51	449 830.84	515 308.23	40 996.77	8.46
45 Gasoline	[illegible]	2 [illegible].95	337 225.18	386 433.35	21 494.89	5.89
46 Lubricants	1 325.49	2 836.14	32 081.40	36 744.03	1 733.02	4.50
47 Other Supplies for Equipment	[illegible]	[illegible].36	11 243.69	12 872.49	847.85	6.18
48 Garage Expenses	4 [illegible].38	7 337.00	83 298.96	95 396.32	6 710.05	6.57
49 Service Equipment Operation	[illegible]	183.04	1 397.53	1 600.76	250.40	19.34
50 Payments to Railroads Emergency Service	[illegible]	432.36	5 475.51	6 237.73	209.60	3.48
51 Loss and Damage Baggage	[illegible]	193 65	2 186.60	2 505.03	626.68	33.36
52 Injuries to Persons	[illegible]	679.97	3 173.24	3 632.80	640.97	21.42
53 Other Transportation Expenses	[illegible]	2 137.73	26 223.50	27 750.07	616.10	2.27
Total Transportation Expenses	[illegible]	204 477.08	1573 247.41	1825 036.42	80 826.78	4.58
V. GENERAL EXPENSES						
60-1 Salaries of General Officers	1 472.37	2 250.75	25 85[illegible] 18	29 605.80	662.86	2.29
60-2 Expenses of General Officers	[illegible]	660.23	7 493.45	8 581.23	3 117.41	36.65
Total Salaries and Expenses of General Officers	1 899.62	2 940.98	33 366.43	[illegible]	2 454.75	6.04
61-1 Salaries of Clerks and Attendants	3 453.22	5 319.36	60 308.69	[illegible]	[illegible]	3.41
61-2 Expenses of Clerks and Attendants	17.32	28.16	308.77	354.25	14.07	4.03
Total Salaries and Expenses of Clerks and Attendants	3 [illegible].54	5 347.52	60 411.46	[illegible]	[illegible]	3.37
62-1 General Office Rents	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
62-2 Other General Office Expenses	182.52	282.16	3 206.17	3 668.85	2 [illegible].65	[illegible]
Total General Office Expenses	182.52	282.16	3 206.17	3 668.85	[illegible]	[illegible]
63 Law Expenses	436 37	769.79	8 718.85	[illegible]	[illegible]	65.79
64 Stationery and Printing	565.44	1 499.38	16 897.70	19 362.52	2 621.38	15.66
65 Other General Expenses	274.38	422.47	4 780.68	5 486.53	565.48	9.34
66-1 Fire Insurance—Buildings and Contents	102.95	159.12	1 802.14	[illegible]	.83	[illegible]
66-2 Fire Insurance on Equipment	270.46	421.12	4 757.89	5 448.89	787.08	12.62
66-3 Personal Injury and Property Damage Insurance	5 529.89	8 587.93	96 808.92	110 926.74	3 681.65	3.21
66-4 Fidelity and Burglary Insurance	39.94	60.94	700.20	801.10	55.08	7.37
66-5 Workmen's Compensation and Other Insurance	88.88	136.20	1 554.97	1 780.00	363.60	16.14
Total Insurance	6 031.88	9 369.33	105 623.52	[illegible]	[illegible]	3.76
Total General Expense	13 300.75	20 589.43	234 191.81	[illegible]	[illegible]	[illegible]
TOTAL OPERATING EXPENSES (Excl. Depreciation)	194 667.12	277 946.45	2399 672.10	[illegible]	[illegible]	[illegible]

TOTAL OPERATING EXPENSES (Excl. Depreciation)	194 667.32	277 946.45	2399 672.10	2873 286.07	139 976.62	4.74
VI. DEPRECIATION						
70-1 Depreciation – Buildings	-	-	12 631.70	12 631.70	647.10	4.87
70-2 Depreciation – Furniture and Fixtures	241.32	344.59	6 667.22	7 253.13	356.52	4.68
70-3 Depreciation – Motor Coaches and Buses	4 245.94	14 013.72	143 040.36	161 300.02	40 369.76	33.38
70-4 Depreciation – Trucks, Automobiles and Tractors	-	-	2 602.85	2 602.85	670.36	34.69
70-5 Depreciation – Machinery Tools and Equipment	308.40	115.08	5 640.40	7 063.88	729.88	9.48
70-6 Depreciation – Improvements on Leased Buildings	-	413.14	4 480.20	4 893.34	481.96	8.96
Total Depreciation	4 795.66	14 894.53	175 062.73	196 744.92	39 696.32	55.44
TOTAL OPERATING EXPENSES (Incl. Depreciation)	199 462.98	292 433.18	2575 736.83	3069 030.99	169 772.94	5.53
TAXES	12 007.61	24 548.94	392 970.94	429 527.49	42 698.38	9.94
TOTAL OPERATING EXPENSES (Incl. Depreciation and Taxes)	211 470.59	317 482.12	2968 707.77	3498 558.48	127 373.68	3.71
NET INCOME FROM OPERATIONS	28 104.99	24 502.64	504 689.08	501 668.67	244 225.94	33.92
OTHER INCOME AND CHARGES – NET	4.33	9.98	2 [illegible]	22 867.96	131.22	.58
NET INCOME	28 100.66	24 520.66	527 563.61	523 [illegible]	244 094.72	33.95
PROFIT AND LOSS ACCOUNTS-NET [illegible] 12-11-56		-	2 439.17	2 439.17	1 [illegible]	-
NET PROFIT (Black) or DEFICIT (Red)	28 100.66	24 520.66	525 104.44	521 334.66	247 784.65	33.21
STATISTICS:						
Average Miles of Routes Operated	293	611	5 156	5 860	97	.98
Revenue Motor Coach Miles	744 780	1152 [illegible]	12998 067	14883 946	183 851	1.22
Revenue Passengers Carried	66 300	200 610	2162 438	2290 676	190 208	9.00
Gasoline—Gallons Consumed	169 274	262 [illegible]	2962 348	3396 [illegible]	66 [illegible]	1.96
—Motor Coach Miles Per Gallon	4.39	4.39	4.39	4.38	.34	3.60
—Average Price Per Gallon (Cents)	11.40	11.39	11.38	11.38	.41	3.74
Number of Coaches Owned	2	8	239	249	7	2.80
Average Number of Coaches Operated Daily	3	18	144	165	5	3.37
Maximum Number of Coaches Operated	34	58	273	277	22	8.03
Total Days all Coaches were Operated	2 929	6 [illegible]	52 776	53 [illegible]	3 [illegible]	4.[illegible]
Average Miles Run Daily Per Motor Coach Operated	253.6	178.8	246.3	279.8	16.3	5.87

There were....38,449.....passengers interchanged between Interstate Transitlines and Union Pacific Stages, Inc.

Auditor's Office.....January 20,.....19.58.....

Note: Amounts reported herein for Account 3, "Passenger Revenue" and 7, "Charter Service Revenue" are based on ticket sales and therefore will not agree with the total revenue reported for the month on Form 600 which is based on tickets honored.

[illegible]

[fol. 81] BEFORE UNITED STATES BOARD OF TAX APPEALS

PRAECIPE FOR TRANSCRIPT—Filed February 2, 1942

To the Clerk of the United States Board of Tax Appeals:

You Are Hereby Requested to prepare and certify and transmit to the Clerk of the United States Circuit Court of Appeals for the 8th Circuit, as the record on petition for review heretofore filed by the petitioner in the above entitled case, the following:

1. Docket entries.
2. The following portions of the petition:

The first paragraph thereof and the paragraphs numbered I, II, III.

Under Paragraph IV entitled "Assignments of Error", the first subparagraph and the second subparagraph marked A.

Under Paragraph V entitled "Facts", the first unnumbered subparagraph and the subparagraphs marked 1, 2, 3, 4, 5, 6, 7, 8 and 9.

Paragraph VI and the prayer for relief.

The following part of Exhibit "A": The deficiency letter and the "Statement", first 8 lines containing the tax liability (being all of pages 11 and 12, except the last two lines, of the petition).

On Page 14 of the petition the title "Explanation of Adjustments" and thereunder subparagraph b (being lines 9 to 14 inclusive on Page 14) and the computation of tax, being the last 15 lines of Page 14. Exhibit "B". Note that this Exhibit "B" is omitted here but is included as "Petitioner's Exhibit 1" with the Statement of Evidence. Exhibit "C". Note that this Exhibit "C" is omitted here but is included as "Petitioner's Exhibit 2" with the Statement of Evidence.

3. The following portions of the answer: The first paragraph thereof and the paragraphs marked I, II, III, IV and of V, subparagraphs 1, 2, 3 to 6, 7, 8 to 13; the unnumbered [fol. 82] paragraph after subparagraph 19 and the prayer for relief.
4. Findings of fact and opinion of Board of Tax Appeals.
5. Decision of the Board of Tax Appeals.
6. Petitioner's motion for reconsideration and the denial thereof.

7. Petition for review of the Board of Tax Appeal's decision by the United States Circuit Court of Appeals.

8. The Statement of Evidence with petitioner's Exhibits 1, 2, 3 and 4 (petitioner's Exhibits 1 and 2, being Exhibits B and C attached to the petition) with respondent's Exhibits A, B and C attached thereto, when the same shall have been settled by the Board.

9. This praecipe.

Dated: November 28, 1941.

Henry W. Clark, Attorney for Interstate Transit Lines. Nelson Trottman, Of Counsel.

[fols. 83-86] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 87] UNITED STATES CIRCUIT COURT OF APPEALS, EIGHTH CIRCUIT, MAY TERM, A. D. 1942

No. 12,247

INTERSTATE TRANSIT LINES, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

On Petition to Review Decision of United States Board of Tax Appeals

OPINION—July 31, 1942

Mr. Nelson Trottman (Mr. Henry W. Clark and Mr. Joseph F. Mann were with him on the brief) for Petitioner.

Mr. Frederic G. Rita, Special Assistant to the Attorney General, (Mr. Samuel O. Clark, Jr., Assistant Attorney General, Mr. Sewall Key and Miss Helen R. Carloss, Special Assistants to the Attorney General, were with him on the brief) for Respondent.

Before Sanborn, Thomas and Riddick, Circuit Judges

[fol. 88] THOMAS, Circuit Judge, delivered the opinion of the court:

In its income tax return for 1936, the petitioner, Interstate Transit Lines, claimed a deduction in the amount of $28,100.66 as a loss sustained by its wholly owned subsidiary, Union Pacific Stages of California, and absorbed by the petitioner under a contract. The Commissioner disallowed the deduction "for the reason that no provision of the Revenue Act of 1936 authorizes such a deduction" and assessed a deficiency in the amount of $4,461.53. The Board of Tax Appeals affirmed the determination of the Commissioner on the ground that the petitioner had not sustained the burden of establishing that the loss of the subsidiary was an ordinary and necessary expense of the parent corporation within the meaning of the applicable statute, § 23(a) of the Revenue Act of 1936, c. 690, 49 Stat. 1648, (44 B.T.A. 957). This statute provides that in computing net income there shall be allowed as deductions "All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."

The taxpayer's petition to review presents the question of whether under the circumstances present the taxpayer, having pursuant to the obligation of a contract paid the operating deficit for 1936 of its subsidiary corporation, is entitled to a deduction on its income tax return therefor as an ordinary and necessary business expense. The inquiry calls for a brief review of the facts giving rise to the problem.

The petitioner is a corporation created under the laws of Nebraska with its principal office at the city of Omaha. Since 1929 it has operated interstate bus lines between Chicago, Illinois, and Los Angeles, California, for the transportation of passengers, mail and express. It had also acquired the right to handle intrastate business in the states [fol. 89] of Iowa, Nebraska, Kansas, Colorado, Wyoming, Utah and Nevada.

Prior to 1937 the petitioner could not acquire the right to do intrastate business in California, because during the period from 1932 and continuing through 1936 the Public Utilities Act of California, Section 50¼, Deering's General Laws of California, 1931, Act 6386, page 3561, provided that

"No passenger stage corporation shall hereafter operate or cause to be operated any passenger stage over any public highway in this state without first having obtained from the

railroad commission a certificate declaring that public convenience and necessity require such operation * * *"

and the railroad commission of California refused to grant certificates for intrastate operations to foreign corporations.

For the purpose of augmenting its income by means of additional revenues derived from carrying California intrastate traffic, the petitioner in 1930 organized under the laws of California the above named wholly owned subsidiary corporation, hereinafter called the subsidiary. Before 1932 the subsidiary had obtained the necessary certificate authorizing it to carry on the desired intrastate operations.

Having thus arranged to carry on both interstate and intrastate business in California the subsidiary and the petitioner in furtherance of the petitioner's purpose and plan entered into two contracts dated February 7 and 8, 1932, respectively. In the record the first contract is referred to as the Absorption Agreement and the second as the Operating Contract. The absorption agreement recited that all the capital stock of the subsidiary is owned by the petitioner; that the petitioner operates busses between various points but operates no busses in California; that the [fol. 90] subsidiary operates busses in California; that the subsidiary is maintained as an operating subsidiary for the sole benefit of the petitioner, and that to secure such benefits it is necessary that the schedules of the two corporations be coordinated. The agreement then provided that the subsidiary agreed to operate busses upon such routes and schedules and under such rules and regulations as may be directed by the petitioner. There was a further stipulation that petitioner would reimburse subsidiary for any deficits incurred in its operations and that subsidiary would pay over to the petitioner any profits resulting from its operations, payments to be made at the end of each calendar year.

The operating contract recited that the petitioner had been operating a passenger business from points east through Las Vegas, Nevada, to Los Angeles, California, doing only an interstate business in the state of California; that the subsidiary contemplated engaging in intrastate operations in the latter state, and that the parties had arranged that the subsidiary would take over as successor all of petitioner's operations in California; that petitioner

would terminate its operations at the California-Nevada state line and there connect with the lines of the subsidiary; and that for convenience and economy it was desirable that the busses of each party run through from its own territory into the territory of the other. It was agreed that as the busses of each party crossed the state line they would pass into the custody of the other party; that as one party took possession of the busses of the other under this arrangement the owner should be designated lessor and the other party lessee; that the lessee should pay the lessor five cents per mile for each mile the bus was operated while in lessee's possession; and that the expense of operation should be apportioned between the parties [fol. 91] monthly, except that each party should pay the taxes on its own busses and that the lessee should be responsible to the lessor for the busses while in the lessee's custody and possession.

There was no change in the conduct of the business after the parties began operating under the latter contract except that intra-California business was available on the busses when operating within that state. No additional expense was incurred other than the cost to the petitioner of keeping the separate accounts for the subsidiary. Both corporations had the same officers and directors. Both contracts were executed for each party by the same person as president of each company. The subsidiary had its own accounting records, employees, busses, directors, and corporate minute book. Its accounting records were kept at the offices of the petitioner by the employees who kept the petitioner's records. The petitioner collected all the revenues of the subsidiary and paid all of its bills. The subsidiary had no separate bank account. The revenues and expenses of both corporations were apportioned monthly on their respective books on the basis of passenger and traffic miles. Corresponding accounts, designated "cash accounts", showing the monthly apportionment were kept on the books of each party. Likewise there was kept in the books of each party a "clearing account" for an entry at the end of each year showing the absorption by the petitioner of the profit or deficit for the year resulting from the operation of the subsidiary.

For the calendar year 1936 the subsidiary incurred an operating deficit of $28,100.66 as shown by its books. At the end of the year this amount was charged to the peti-

tioner in the clearing account of the subsidiary and credited to the subsidiary in the clearing account of the petitioner.

[fol. 92] At all times the accounts of both corporations were kept on an accrual basis.

The petitioner contends that in computing its 1936 income it is entitled to deduct as an ordinary and necessary expense the item of $28,100.66 representing the deficit of its California subsidiary for that year. Briefly the basis of this contention is (1) that the subsidiary was the agent of petitioner in carrying the interstate traffic in California, hence the total expense including the deficit was an ordinary and necessary expense of petitioner; (2) that the payment was made in performance of a contractual obligation; and (3) that because of the close integration of the two corporations the subsidiary must be considered only an instrumentality or a department of the petitioner's business, on the principle that substance and not form should govern in order to achieve equal equity.

As a foundation for these contentions it is argued (1) that the total expenses allocable to carrying the interstate traffic in California would, with the exception of the cost of bookkeeping, have been the same as it was for carrying both the interstate and the intrastate traffic, and that equivalent expenses would have been borne by petitioner had the subsidiary not been organized and the absorption contract made; (2) that the deduction is not claimed merely because petitioner owned all the stock of the subsidiary; and (3) that the formal separate corporate entities should under the circumstances be disregarded.

The Board held that the petitioner failed to sustain the burden of establishing that the accrual was an ordinary and necessary expense of the petitioner for the reasons, in part, (1) that the subsidiary was a separate, juristic taxable entity, and that its business in California was not the business of the petitioner; (2) that there is no evidence of [fol. 93] the ordinary and necessary expense of furnishing interstate transportation within the state of California, so that it cannot be determined whether all of the operating deficit of the subsidiary for the taxable year was attributable to the intrastate business of that company; and (3) that the subsidiary was not created nor the deficit made to increase the profits of the business of the petitioner. These things were done to augment the petitioner's income by increasing

the income of its subsidiary from revenues derived from the intrastate business in which the petitioner could not engage. Under these circumstances the Board held that payment of the deficit by the petitioner was in the nature of a capital expenditure and not an expense of carrying on the petitioner's own business.

In determining whether the Board erred in holding that the petitioner failed to sustain the burden of establishing that the payment involved was an ordinary and necessary business expense of the petitioner we must consider whether as a matter of law the evidence compels the conclusion that the payment was a business expense rather than a capital expenditure.

The petitioner's first two contentions are in effect parts of a single argument. Stated briefly the substance of the contentions is that carrying interstate traffic in California was a part of the petitioner's business; that the petitioner employed the subsidiary as its agent to carry its interstate traffic in California, and that as part consideration for such service it agreed to pay the subsidiary's deficits, if any; and, therefore, the payment of the 1936 deficit was an ordinary and necessary contractual business expense. In this statement of the petitioner's contentions we accept the theory that the expense of carrying intra-California traffic may be disregarded as insignificant. Even so, the argument ignores the facts. Assuming that the subsidiary was [fol. 94] an agent of the petitioner as a carrier of its interstate traffic in California, the absorption contract obligating the petitioner to pay the subsidiary's deficits does not place the obligation upon the ground of payment for any service rendered or to be rendered by the subsidiary. The amount of the deficit to be paid is not made dependent upon any corresponding unit of benefit to the petitioner or sacrifice of the subsidiary. In fact revenues of the respective companies were apportioned monthly "on the basis of passenger and traffic miles, compared to the aggregate of the same." The deficit of 1936 was consequently an incident attributable wholly to the business of the subsidiary. Standing alone the fact that payment was the result of a contractual obligation does not render it an ordinary business expense. *Deputy* v. *du Pont*, 308 U. S. 488.

It is next argued that the close integration of the petitioner and of its subsidiary makes clear the fact that the subsidiary was but an agent or instrumentality of the peti-

tioner; that the business of the subsidiary was but a department of the petitioner's business; and that, therefore, the corporate entity of the subsidiary should be disregarded for tax purposes. In support of this thesis reliance is placed upon such cases as *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330; *Gulf Oil Corporation* v. *Lewellyn*, 248 U. S. 71; *North Jersey Title Insurance Co.* v. *Commissioner*, 3 Cir., 84 F. 2d 898; *United States* v. *Brager Building & Land Corp.*, 4 Cir., 124 F. 2d 349; and *Inland Development Co.* v. *Commissioner*, 10 Cir., 120 F. 2d 986. These cases cannot be regarded as laying down any general rule authorizing disregard of corporate entity in respect of taxation. They present peculiar situations and were determined upon consideration of them. *Burnet* v. *Commonwealth Imp. Co.*, 287 U. S. 415, 420; *American Package Corporation* v. *Commissioner*, 4 Cir., 125 F. 2d 413, 415. The cases relied upon are not controlling here.

[fol. 95] The subsidiary in this case was organized primarily to do a business which the petitioner had no authority to do, and was used to carry on an active business for profit.

The general rule applicable to such cases was stated by Mr. Justice Van Devanter, speaking for the court in *New Colonial Co.* v. *Helvering*, 292 U. S. 433, 440, wherein he said: "• • • the statutes have disclosed a general purpose to confine allowable losses to the taxpayer sustaining them, i. e., to treat them as personal to him and not transferable to or usable by another." In *Higgins* v. *Smith*, 308 U. S. 473, 477, construing its own decision in *Burnet* v. *Commonwealth Improvement Company, supra*, the Supreme Court said specifically that, "A taxpayer is free to adopt such organization for his affairs as he may choose and having elected to do some business as a corporation, he must accept the tax disadvantage." But the government "may sustain or disregard the effect of the fiction as best serves the purpose of the tax statute." In *Watson* v. *Commissioner*, 2 Cir., 124 F. 2d 437, 439, the court held the language of the *Higgins case, supra*, to be conclusive. This court has recognized the rule as binding and followed it in *Helvering* v. *Jane Holding Corporation*, 8 Cir., 109 F. 2d 933, 943, and in *United States* v. *Donaldson Realty Co.*, 8 Cir., 106 F. 2d 509. Compare *Webber* v. *Knox*, 8 Cir., 97 F. 2d 921, 923; *Commissioner* v. *Trustees of Lumber Inv. Ass'n*, 7 Cir., 100 F. 2d 18, 28; *Planters' Cotton Oil Co.* v. *Hopkins*, 5 Cir., 53 F. 2d 825, 827; *New Colonial Co.* v. *Helvering*, 292 U. S. 435,

441; *In re Collins*, 8 Cir., 75 F. 2d 62, 64; *United Light & Power Co.* v. *Commissioner*, 7 Cir., 105 F. 2d 866, 878; and *Consumers Const. Co.* v. *Commissioner*, 1 Cir., 94 F. 2d 731, 734.

The Board correctly applied the law to the facts. The corporate entity of the subsidiary cannot be disregarded, nor the "tax disadvantage" resulting from its organization avoided. *Higgins* v. *Smith, supra.*

[fol. 96] We also agree with the Board that the payment by the petitioner of the deficit of the subsidiary was a capital expenditure, not an ordinary and necessary expense of the petitioner's business.

The conditions which distinguish a capital investment from an ordinary and necessary business expense in cases where a stockholder contributes something to his corporation have been settled, not by unanimity of decision but by clear weight of authority.[1] If the contribution (1) is a benefit to or has value to the stockholder and (2) becomes an asset of the corporation when transferred to it, the stockholder increases his capital investment in the corporation, and the payment is not a deductible business expense. Whether such payment was made by reason of a contractual

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[1] *Welch* v. *Helvering*, 290 U. S. 111; *Athol Mfg. Co.* v. *Commissioner*, 1 Cir., 54 F. 2d 230; *Menihan* v. *Commissioner*, 2 Cir., 79 F. 2d 304, 306, cer. den., 296 U. S. 651; *Atlantic Coast Line R. Co.* v. *Commissioner*, 4 Cir., 81 F. 2d 309, cer. den., 298 U. S. 656, rehear. den., 298 U. S. 691; *United States* v. *Donaldson Realty Co.*, 8 Cir., 106 F. 2d 509; *Jenkins* v. *Bitgood*, 2 Cir., 101 F. 2d 17; *In re Park's Estate*, 2 Cir., 58 F. 2d 965, 966; *Pennsylvania Indemnity Co.* v. *Commissioner*, 3 Cir., 77 F. 2d 92; *Burns* v. *Commissioner*, 5 Cir., 31 F. 2d 399, cer. den., 280 U. S. 564; *First Nat. Bank in Wichita* v. *Commissioner*, 10 Cir., 46 F. 2d 283. See also *Commissioner* v. *Hadley*, 2 Cir., 75 F. 2d 485, 487; *Kistler* v. *Burnet*, App. D. C., 58 F. 2d 687; *Hamlen* v. *Welch*, 1 Cir., 116 F. 2d 413, 419; *American Cigar Co.* v. *Commissioner*, 2 Cir., 66 F. 2d 425; *Newark Milk & Cream Co.* v. *Commissioner*, 3 Cir., 34 F. 2d 854; *Newspaper Printing Co.* v. *Commissioner*, 3 Cir., 56 F. 2d 125. Cf. *Wiggins* v. *Commissioner*, 1 Cir., 46 F. 2d 743; *Shiman* v. *Commissioner*, 2 Cir., 60 F. 2d 65; *New York, C. & St. L. R. R. Co.* v. *Helvering*, App. D. C., 71 F. 2d 956; *Hill* v. *Commissioner*, 1 Cir., 38 F. 2d 165, 168.

obligation or was merely a voluntary act does not affect the result.

In this case payment of the deficit was made for the sole benefit of the petitioner, and the contribution became an asset of the subsidiary. The subsidiary had no purplus. Under the absorption agreement all the profits earned by it during the preceding years of its existence, amounting approximately to $75,000, had been paid over to the petitioner. Payment by the subsidiary of its $28,100.66 operating deficit for 1936 would have impaired its capital to that extent. Payment of this sum by the petitioner was equivalent to a contribution of capital assets to the subsidiary, [fol. 97] made to maintain the capital structure of the subsidiary in order to enable it to continue in business for the purpose of augmenting the petitioner's income. Such a contribution by a stockholder is a capital expenditure, not an ordinary and necessary business expense.

The decision of the Board is affirmed.

[fol. 98] UNITED STATES CIRCUIT COURT OF APPEALS, EIGHTH CIRCUIT

INTERSTATE TRANSIT LINES, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE

On Petition to Review Decision of United States Board of Tax Appeals

JUDGMENT—July 31, 1942

This cause came on to be heard on the petition to review the decision of the United States Board of Tax Appeals redetermining that there is a deficiency in the income tax of the petitioner for the calendar year 1936, on the record of the proceedings before the said Board, and was argued by counsel.

On Consideration Whereof, it is now here Ordered and Adjudged by this Court that the order of the said Board of Tax Appeals in this cause be, and the same is hereby, affirmed.

And it is further ordered by this Court that the petition to review in this cause be, and the same is hereby, dismissed without the taxation of costs in favor of either of the parties in this Court.

July 31, 1942.

[fol. 99] In United States Circuit Court of Appeals

[Title omitted]

Petition for Rehearing—Filed August 14, 1942

Now comes the above named petitioner, Interstate Transit Lines, and moves for a rehearing of the above entitled cause for the reasons hereinbelow set forth.

On page 2 of the typewritten opinion in this cause is set out a part of Section 50¼ of the California Public Utilities Act, Deering's General Laws of California, 1931, Act 6386 (page 3561), in which it is provided that no passenger stage corporation shall operate or cause to be operated any passenger stage over any public highway in California without first having obtained from the railroad commission a certificate declaring that public convenience and necessity require such operation. No mention is made [fol. 100] of Section 26 of the same Act, which was passed in 1915 and contained the following clause:

"provided, that foreign corporations engaging in commerce with foreign nations or commerce among the several States of this Union may transact within this State such commerce and intrastate commerce of a like character."

Further, whether or not the language just quoted was impliedly repealed by Section 50¼ (passed in 1927), this language was re-enacted in 1935, prior to the taxable year involved in this cause, and was in effect throughout 1936. (See pages 19 and 20 of our original brief herein.)

It follows, therefore, that there is an inaccuracy in the following sentence appearing on page 6 of this court's typewritten opinion:

"These things were done to augment the petitioner's income by increasing the income of its subsidiary from revenues derived from the intrastate business *in which the petitioner could not engage.*" (Italics ours.)

The italicized words are incorrect.

Likewise on page 8 of the typewritten opinion appears the following sentence:

"The subsidiary in this case was organized primarily to do a business *which the petitioner had no authority to do,* and was used to carry on an active business for profit." (Italics ours.)

The italicized words in the above sentence are likewise incorrect.

Plainly, in 1936 the taxpayer did have authority itself to carry on intrastate business in California, so that there was in the fact of Stages' separate existence that year no element of avoidance of the local law. The record shows that there was no advantage of any kind obtained [fol. 101] by taxpayer by reason of the separate corporate entity apart from the transaction of local business, which, when Stages was organized, was probably but a subjective concept of the taxpayer and of the Commission. But however that may have been at the time Stages was organized, there was no such advantage in the taxable year. This is not a case of a taxpayer seeking to avail itself of the advantages of the separate corporate entity without bearing the tax disadvantages. Because the apparent lack of authority to carry on the local business was stressed both by the Board's opinion and that of this court, and because that seems to have had a controlling effect in the result, in each case, petitioner desires to call attention to this inaccuracy, and requests further consideration in the light of the fact that in the taxable year there was no prohibition against the taxpayer's carrying on the local business.

In another respect the opinion is not entirely clear. The opinion quotes (on page 8 of the typewritten opinion) language from the Supreme Court's opinion in *Higgins* v. *Smith*, 308 U. S. 473, 60 S. Ct. 355, 80 L. Ed. 406, to the effect that a taxpayer is free to adopt such organization for his affairs as he may choose and "having elected to do some business as a corporation, he must accept the tax disadvantage," and the further language that the Government "may sustain or disregard the effect of the fiction as best serves the purpose of the tax statute." It is not clear from the opinion whether by this language it is intended to hold that in no circumstances may a taxpayer who has himself set up the corporate entity ever disregard

that corporate entity. If it is intended so to hold, this opinion is contrary to *United States* v. *Brager Building & Land Corp.*, 124 Fed. (2d) 349. It is difficult to see how the doctrine of the disregard of corporate entity can ever be applied at a taxpayer's instance if it is not to be ap-
[fol. 102] plied to the present case; and for this reason it is earnestly submitted that the present holding is contrary to the line of authorities, some of which are cited on pages 7 and 8 of the opinion, commencing with *Southern Pacific Ry.* v. *Lowe*, 247 U. S. 330, 38 S. Ct. 540, 62 L. Ed. 1142. While it is true that some factual differences exist, it is by no means clear from the opinion herein that this Court has distinguished these cases solely upon factual grounds. Rather does the quoted language from *Higgins* v. *Smith, supra* suggest that *what has actually been held in the present case is that under virtually no circumstances can the corporate entity ever be disregarded at a taxpayer's instance.* This conclusion is further suggested by a sentence (on the top of page 9 of the typewritten opinion) reading:

"The corporate entity of the subsidiary cannot be disregarded, nor the 'tax disadvantage' resulting from its organization avoided,"

for which *Higgins* v. *Smith, supra*, is cited.

There have been numerous decisions in which at the taxpayer's instance the corporate entity has been disregarded; but cases like the present one, *Keystone Mining Co.* v. *Gray*, 120 Fed. (2d) 1, and *Superior Coal Co.* v. *Department of Finance*, 337 Ill. 282, 36 N. E. (2d) 354, are, to say the least, difficult to reconcile with the other line of cases of which *Southern Pacific Ry.* v. *Lowe* was the forerunner. Whatever the law may be, whether favorable or unfavorable to taxpayers, it is desirable that it be clarified. It is therefore earnestly submitted that this would be an appropriate case for a clear pronouncement on this subject. Whether or not taxpayer is, under the law, entitled to prevail, the facts tending to support disregard of the corporate entity in the present case are
[fol. 103] unusually strong, particularly if the inaccuracy with respect to the California law is corrected. While perhaps not as strong a factual case as the *Brager Building & Land Corporation* case, 124 Fed. (2d) 349, the case at bar is, if anything, stronger for the taxpayer than the

Inland Development Company case, 120 Fed. (2d) 986, and some of the other cases referred to. Because of this, and because of the language used in the opinion, it would seem that this court has held, in this case, that *under no circumstances* can the corporate entity ever be disregarded *at the instance of the taxpayer.* Yet, because the opinion is not clear on this point, the already confused state of the law is by the precedent created by the present case, even more confused.

It is submitted therefore that the opinion is incorrect in the important respect relating to the effect of the California law, and also seems in conflict with some of the other cases on the legal question whether under *any* circumstances the corporate entity may at a *taxpayer's* instance be disregarded.

For these reasons the taxpayer requests a reconsideration of this cause.

Respectfully, Joseph F. Mann, Nelson Trottman, Attorneys for Petitioner.

The undersigned Counsel for Interstate Transit Lines, the above named petitioner, hereby certify that the above and foregoing petition is filed in good faith and is believed to be meritorious, and is not filed for the purpose of delay.

Joseph F. Mann, Nelson Trottman.

[File endorsement omitted.]

[fol. 104] In United States Circuit Court of Appeals

Order Denying Petition for a Rehearing—September 8, 1942

The petition of the petitioner for a rehearing of this cause having been considered by this Court, It is now here Ordered by the Court that said petition be, and the same is hereby, denied.

September 8, 1942.

[fol. 105] In United States Circuit Court of Appeals

Motion for Stay of Mandate—Filed September 11, 1942

Now comes the above named petitioner and moves for a stay of this Court's mandate for a period of thirty (30)

days from and after September 19, 1942, in order to enable petitioner to complete the preparation and filing of its application to the United States Supreme Court for a writ of certiorari to review the decision of this Court in the above entitled cause.

Dated this 9th day of September, 1942.

Joseph F. Mann, Nelson Trottman, Attorneys for Petitioner.

To Hon. Samuel O. Clark, Jr., Assistant Attorney General, Washington, D. C.

Please take notice that the above named petitioner will file with the Clerk of the United States Circuit Court of Appeals for the Eighth Circuit, on September 11, 1942, a motion for a stay of mandate herein for a period of thirty (30) days from and after September 19, 1942, in order to enable petitioner to prepare and file its application to the United States Supreme Court for a writ of certiorari to review the decision of this Court in the above entitled cause.

Dated this 9th day of September, 1942.

Joseph F. Mann, Nelson Trottman, Attorneys for Petitioner.

[fol. 106] Affidavit of Mailing

State of Illinois,
County of Cook, ss:

Jeanne Gates, being first duly sworn, on oath deposes and says that on September 9, 1942, she deposited in the United States Mails, for transmission by air-mail, with air mail postage fully prepaid, addressed to Hon. Samuel O. Clark, Jr., Assistant Attorney General, Washington, D. C., the original of the attached notice, and at the same time also deposited in the mails addressed to the Honorable Samuel O. Clark Jr., a copy of petitioner's motion for stay of mandate, for like transmission by air mail, with air mail postage fully prepaid.

Jeanne Gates.

Subscribed and sworn to before me this 9th day of September, 1942. Margaret C. Carmody, Notary Public. (Seal.)

[File endorsement omitted.]

[fol. 107] In United States Circuit Court of Appeals, September Term, 1942

Order Staying Issuance of Mandate—September 14, 1942

Monday, September 14, 1942.

On Consideration of the motion of petitioner for a stay of the mandate in this cause pending a petition to the Supreme Court of the United States for a writ of certiorari, It is now here ordered by this Court that the issuance of the mandate herein be, and the same is hereby, stayed for a period of thirty days from and after this date, and if within said period of thirty days there is filed with the Clerk of this Court a certificate of the Clerk of the Supreme Court of the United States that a petition for writ of certiorari, record and brief have been filed, the stay hereby granted shall continue until the final disposition of the case by the Supreme Court.

September 14, 1942.

[fol. 108] In United States Circuit Court of Appeals

Motion for Further Stay of Mandate—Filed October 12, 1942

Now comes the above named petitioner and moves for a further stay of this Court's mandate for a period of forty-five (45) days from and after October 19, 1942, in order to enable petitioner to complete the preparation and filing of its application to the United States Supreme Court for a writ of certiorari to review the decision of this Court in the above entitled cause, the reasons for this motion being those stated in the Affidavit of Counsel heretofore attached.

Dated this 8th day of October, 1942.

Joseph F. Mann, Nelson Trottman, Attorneys for Petitioner.

Affidavit

State of Illinois,
County of Cook, ss:

Nelson Trottman, being first duly sworn, on oath deposes and says:

1. That he is one of the attorneys for the petitioner in the above entitled cause;

2. That deponent's associate counsel is in New York and that other counsel in the employ of the Interstate Transit Lines, but not formally representing petitioner in this cause, are located in Omaha, Nebraska; that it has not yet been determined finally whether or not an application should be made for a writ of certiorari in this cause; that deponent is obliged to take up with such associate counsel in New [fol. 109] York, and with counsel in Omaha, the question whether or not to apply for such writ; that this would in any event have entailed some delay in coming to a decision because of the distance deponent is from both associate counsel and counsel in Omaha, but that further delay has inevitably resulted by reason of the severe illness of said New York counsel; that said counsel has been confined to his home since about the first of September and deponent is informed and believes, although he is much improved and is now able to be up and around his home, he will not return to his office and be available for conference until well toward the end of the present month;

3. That this Court's petition for rehearing was denied on September 8, 1942, and that under the rules covering the filing with the Supreme Court of petitions for writ of certiorari the time for filing such petition herein will not expire until December 7, 1942.

4. That in order that a determination can be arrived at after full and mature consideration of the question whether an application for review of this Court's decision should be made to the Supreme Court, the extension requested in this motion is necessary, for the reasons hereinabove set forth, so that if it is determined that such petition be filed it may be filed before the issuance of this Court's mandate.

Nelson Trottman.

Subscribed and sworn to before me this 8th day of October, 1942. Margaret C. Carmody, Notary Public. (Seal.)

[Endorsed:] Filed in U. S. Circuit Court of Appeals, Oct. 9, 1942.

[fol. 110] State of Illinois,
County of Cook, ss:

Jean Keilogg, being first duly sworn, on oath deposes and says that on October 8, 1942, she deposited in the United States Mails, with postage prepaid, addressed to

Hon. Samuel O. Clark, Jr., Assistant Attorney General, Washington, D. C., the original of the attached notice, and at the same time also deposited in the mails, addressed to said Hon. Samuel O. Clark, Jr., a copy of petitioner's motion for a further stay of mandate, together with affidavit of counsel thereto attached.

Jean Kellogg.

Subscribed and sworn to before me this 8th day of October, A. D. 1942. Margaret C. Carmody, Notary Public. (Seal.)

To: Hon. Samuel O. Clark, Jr., Assistant Attorney General, Washington, D. C.

Please take notice that the above named petitioner will file with the Clerk of the United States Circuit Court of Appeals for the Eighth Circuit, on October 12, 1942, a motion for a further stay of mandate herein for a period of [fol. 111] forty-five (45) days from and after October 19, 1942, in order to enable petitioner to prepare and file its application to the United States Supreme Court for a writ of certiorari to review the decision of this Court in the above entitled cause. A copy of said motion with affivadit of counsel attached thereto is transmitted herewith.

Dated this 8th day of October, 1942.

Joseph F. Mann, Nelson Trottman, Attorneys for Petitioner.

In United States Circuit Court of Appeals

Order Further Staying Issuance of Mandate—October 20, 1942

On Consideration of the motion of Petitioner for a further stay of the mandate in this cause for a period of forty-five days from and after October 19, 1942, pending a petition to the Supreme Court of the United States for a writ of certiorari, It is now here ordered by this Court that the issuance of the mandate herein be, and the same is hereby, further stayed for a period of forty-five days from and after October 14, 1942, and if within said period of further stay there is filed with the Clerk of this Court a certificate of the Clerk of the Supreme Court of the United States that

a petition for writ of certiorari, record and brief have been filed, the further stay hereby granted shall continue until the final disposition of the case by the Supreme Court.

October 20, 1942.

[fol. 112] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 113] SUPREME COURT OF THE UNITED STATES, OCTOBER TERM, 1942

No. 552

[Title omitted]

ORDER ALLOWING CERTIORARI—Filed March 8, 1943

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Eighth Circuit is granted, and the case is transferred to the summary docket.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

FILE COPY

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IN THE

Supreme Court of the United States

No. 552

INTERSTATE TRANSIT LINES,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI
To United States Circuit Court of Appeals
For the Eighth Circuit.

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MCCORMICK AND HENDERSON, INC., CHICAGO

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IN THE

Supreme Court of the United States

No.

INTERSTATE TRANSIT LINES,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI
To United States Circuit Court of Appeals For the Eighth Circuit.

TO THE HONORABLE CHIEF JUSTICE AND ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

Your petitioner, Interstate Transit Lines respectfully prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Eighth Circuit, entered on July 31, 1942, in a cause numbered and entitled on its Docket No. 12247, Interstate Transit Lines, Petitioner, vs. Commissioner of Internal Revenue, Respondent, affirming the decision of the United States Board of Tax Appeals. Petition for rehearing was denied September 8, 1942.

OPINIONS BELOW.

The opinion of the Board of Tax Appeals is reported at 44 B.T.A. 957. The opinion of the Circuit Court of Appeals is reported at 130 Fed. (2d) 136.

STATUTE INVOLVED.

The Statute involved is section 23(a) of the Revenue Act of 1936, 48 St. L. 1658 (set out, *infra*. in the appendix).

SUMMARY STATEMENT OF MATTER INVOLVED.[1]

(Numerals in parentheses refer to pages[2] of the printed record.)

This proceeding is an income tax case involving the taxable year 1936. The Board of Tax Appeals (now the Tax Court), in a decision rendered July 9, 1941 (21) found a deficiency in petitioner's income tax for 1936 in the sum of $4,461.53, 44 B.T.A. 957. The Circuit Court of Appeals affirmed (86) 130 Fed. (2d) 136. This petition is to obtain a review of that decision.

Substantially all of the deficiency is predicated upon the disallowance by the Commissioner of an item of $28,100.66, which represents the amount by which operating expenses, in 1936, of a wholly owned and dominated subsidiary, Union Pacific Stages of California (herein for brevity referred to as "Stages"), exceeded the latter's operating revenue. The taxpayer, the petitioner (herein sometimes referred to as "Interstate"), actually, and without any offsetting benefit or consideration other than the subsidiary's conduct of taxpayer's business operations in California, both interstate and intrastate, bore the

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[1] In this summary evidence concerning details of accounting is omitted as not relevant to the question of the propriety of a review by this court. Only so much of the evidence is summarized herein as bears upon the question of the subsidiary's agency for the parent taxpayer, and that of the effect of the assumption by one corporation, pursuant to contract, of payments to another corporation conducting operations on the former corporation's behalf of otherwise deductible expense items, these being the questions involved here, as to which the law is, taxpayer believes, in a very unsettled state, with the decisions in hopeless conflict.

[2] Page references are to the printed copies filed herewith. The paging of the original differs slightly, in that portion setting out the Circuit Court of Appeals proceedings.

burden of this deficit, which resulted entirely from operations performed in California by Stages for the petitioner. This was done pursuant to a contract between Interstate and Stages entered into in 1932. No part of the claimed deduction represented any advance for capital purposes, and but for the allocation, as between the two companies, hereinafter mentioned, to Stages of revenues and expenses from California interstate and intrastate business, would without any question be proper to reflect as a deduction. There is no dispute over the items producing the figure of $28,100.66. The Commissioner disallowed it on the stated ground that "no provision of the Revenue Act of 1936 authorizes such deduction" (9). Taxpayer claims the deduction under section 23(a) of the Revenue Act of 1936, 48 St. L. 1658, as an "ordinary and necessary expense" of carrying on its business.

The facts are not in dispute. Interstate Transit Lines, a Nebraska corporation, has since 1929 been engaged in the interstate bus transportation business between Chicago and Los Angeles, and Kansas City and Cheyenne, and had by 1930 acquired the right to handle intrastate business in numerous states, but not California. The Railroad Commission of that State (probably erroneously under the State law) had a settled policy of refusal[1] to

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[1] The Commission's policy appears to have been bottomed on a California Statute passed in 1927. Section 50¼ of the California Public Utilities Act (Deering's General Laws of California, 1931, Act 6386, page 3561, incorrectly given as page 3161 on page 5 of Transcript), adopted in 1927 (Session Laws, 1927, p. 74; amended in 1931 in a manner not here material, Session Laws, 1931, p. 2598), provided in part:

> "No passenger stage corporation shall hereafter operate or cause to be operated any passenger stage over any public highway in this state without first having obtained from the railroad commission a cer-

issue to a foreign corporation the prerequisite certificate of convenience and necessity for the conduct of intrastate business. Whether or not the Commission prior to 1930 correctly construed the California law (which the marginal footnote references, *infra*, indicate was most doubtful) there was in 1936 no State statutory inhibition in effect which in that year would have prevented Interstate from carrying California local passengers. Because, however, of the attitude of the California Commission, Interstate

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tificate declaring that public convenience and necessity require such operation."

However, Section 26 of the California Public Utilities Act (Deering's 1935 Supplement to California General Laws, Act 6386, page 1622), in effect throughout 1936, contains the following proviso:

> "provided, that foreign corporations engaging in commerce with foreign nations or commerce among the several States of this Union may transact within this State such commerce and intrastate commerce of a like character; and, provided, further, that any foreign corporation, which may comply with the laws of this State respecting foreign corporations, and which owns at least ninety per cent of the outstanding capital stock of any other foreign corporation transacting a public utility business in this State, may succeed to the public utility business, franchises and rights of such latter corporation and, thereafter continue and carry on such public utility business."

The first five lines of the foregoing (to the semicolon) have been in effect since 1915 (Session Laws, 1915, p. 130). The balance of the above language was added by the 1935 amendment (Session Laws, 1935, p. 1564). Whether or not the 1927 amendment (appearing as Section 50¼, *supra*) affected Section 26 as it existed prior to 1927, the 1935 amendment, just quoted, reenacting Section 26 as it had been and adding the second proviso, makes it clear that it was in effect in 1936.

appeared unable itself, prior to and during 1930, to carry intrastate passengers. Being desirous to secure that traffic and add the revenue therefrom to its interstate revenue (36) and thus obtain additional passengers for vacant seats in its through buses without having to incur additional expenses (38), taxpayer for this purpose in 1930 organized Stages under the California laws. By 1932 Stages had, with the State Commission's approval, secured the franchise necessary for intrastate operation. Interstate furnished all Stages' capital and received all its stock. (No part of this capital investment is in any way involved in the present proceeding.)

Formal contracts, dated February 7, and 8, 1932 (respectively referred to as the "absorption" and "operating" agreements) were executed by parent and subsidiary. Neither contract was suggested by or involved any element of tax avoidance, or at the time made had any tax significance, one way or the other, because the companies then filed consolidated returns. The "absorption" contract recited among other things that Stages was maintained as an operating subsidiary of taxpayer and that its operations were conducted solely for Interstate's benefit, and provided, among other things, that Interstate would "assume and reimburse the California corporation for any deficits incurred by the California corporation in its operations" (Petitioner's Exhibit 1, 61-63). It was pursuant to this provision that the taxpayer assumed and bore Stages' 1936 deficit, $28,100.66, the sole item here in controversy.

The "operating" agreement provided, in substance, that buses of Interstate (which had theretofore operated its buses through to Los Angeles) should on each trip continue through, but at the State line should pass into Stages'

custody and that Stages' buses[1], traveling northward, were at the State line to pass into Interstate's custody. Each party leased its buses to the other, while thus in the other's custody, for five cents per bus mile while in such custody, the lessee in such instance to bear expenses (other than drivers' wages and taxes) and insurance properly attributable to the buses while in its possession. Drivers were to be the employes of and their wages paid by the lessee while in service in connection with leased buses, the effect of which was to make drivers the formal employes of Stages while in California and of Interstate when outside of California. (All drivers were actually paid by Interstate, *infra*, p. 7.) Each party was to pay taxes on its own buses (Petitioner's Exhibit 2, 63-65).

The pleadings admit (15) the very important fact (thereby making it a verity in this case) that Interstate, the taxpayer, was during 1936 engaged in the operation of motor buses for the transportation of passengers between Chicago and Los Angeles. Notwithstanding this admitted fact, no part of the net cost of that operation, $28,100.66, has been held deductible[2]. Ignoring this admission, both tribunals below treated Interstate's supposed want of authority to transact California intrastate business as a decisive factor; but by 1936 there was no longer any lawful impediment to the transaction by Interstate of local

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[1] Two buses were bought in 1932, nominally by Stages, with capital funds contributed by Interstate. These were "operated in a pool with the parent company's buses" (39).

[2] The Circuit Court of Appeals ignored this formal admission of one of the important facts involved, and, although conceding (92), *arguendo*, in effect that the deficit arose from Interstate business, erroneously said (*ibid*) that the deficit was "an incident attributable wholly to the business of the subsidiary".

business, and at no time was there ever any impediment to Interstate's transaction of interstate business in which the respondent has, in his pleading, admitted taxpayer was itself engaged in 1936. The cost of taxpayer's operation, through Stages, of both interstate and intrastate business was not attributable to intrastate operation; for under the arrangement outlined, the California local business continued to be handled without any additional expense, on the same buses previously operated by the taxpayer (38). There were the same schedules and no physical changes whatever, the only change being in bookkeeping. There was no break in the operation of buses or change of passengers at the State line, and no additional expense was created by the California local business except possibly a slight additional expense in accounting (18; 38, 39). The trifling and even nebulous character of this additional expense, if such there was, is pointed out in testimony (46) which is uncontroverted, and in the opinion below is assumed to be the fact (92) *infra*[1]. Therefore the expense which produced the deficit in question was the expense of conducting the interstate business of the taxpayer.

The record amply establishes the fact that Stages was but a branch or department of Interstate, and its agent in the conduct of the business. The companies had the same officers and directors. Stages' accounting records, though kept separately, were kept at taxpayer's office and by taxpayer's officers and employees. Stages never had any bank account. Its revenue and expenses were handled by taxpayer as its banker. It had no pay-roll. Employes below the classification of general officers (whose salaries were apportioned on the books) who participated in the conduct of the California business were carried only on taxpayer's payrolls and paid by taxpayer vouchers, without segregation for services performed in California. In-

[1] On page 9.

terstate collected all Stages' revenue and paid all its bills, payrolls and otherwise (see 18, 43-46).

While in a very limited sense it is literally true, as recited in the findings, that Stages had its own accounting records, employes, buses, directors and corporate minute book, yet all employes of both companies were carried on Interstate payrolls and for all services performed, whether nominally for Interstate or Stages, were paid by Interstate checks. Payroll payments with respect to California operations were apportioned on a revenue motor coach mile basis (44). The findings do recite that taxpayer "paid all of the bills, payroll and otherwise, of Stages" (18).

Revenues were collected and retained by Interstate, and allocated on the books by assigning California intrastate revenue directly to Stages, and assigning interstate California revenue on a passenger mile basis (18, 44, 45). Total revenues thus allocated to Stages for 1936 were $183,365.60 (Respondent's Exhibit C, 77, 79) of which no more than something "in excess of" $10,000 represented intrastate revenues (38).[1] Expenses of carrying all traffic allocated to Stages were $211,470.59 (Respondent's Exhibit C, 77, 79). All this aggregate expense, under the uncontroverted evidence, was what it cost to carry on (through Stages' agency) the interstate operation admitted by the pleadings to have been engaged in by Interstate. The difference between the two figures of $211,470.59 and $183,365.60 (except for a minor and immaterial adjustment) represents the item of $28,100.66 [2] here in controversy. Taxpayer claims

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[1] The record does not show the exact figure. The estimate is that of the Vice President, and the amount was not controverted.

[2] The expense of carrying on the California part of the business was $211,470.59. The revenues allocated to California were $183,365.60. Taxpayer had the economic benefit

the right to this deduction as an ordinary and necessary expense of carrying on its business, through its agent, Stages.

The Circuit Court of Appeals, accepting what it termed "the theory that the expense of carrying intra-California traffic may be disregarded as insignificant", and "assuming that the subsidiary was an agent of the petitioner as a carrier of its interstate traffic in California", took the view (92) that the absorption contract did not place the obligation upon the ground of payment for any service rendered, because the amount of the deficit was "not made dependent upon any corresponding unit of benefit to the petitioner or sacrifice of the subsidiary", from which asserted circumstance the court, in complete disregard of the formal admission in the pleadings, concluded that "the deficit of 1936 was consequently an incident attributable wholly to the business of the subsidiary". The court held further (94) that the contract payment (although representing the excess of Stages' operating expenses incurred in conducting the taxpayer's business over revenues) was a capital expenditure, not an ordinary and necessary expense of taxpayer's business. In this connection the court made the assertion that the legal question involved had been "settled"; but in the same connection said that it was "not by unanimity of decision but by clear weight of authority", thus recognizing that there are contrary authorities. The court also rejected the taxpayer's contention that the close integration of the two companies was such as to make this a proper case for the application at taxpayer's instance of the "agency" doctrine, or doctrine of disregard of corpo-

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of the latter sum, bore the economic burden of the former sum, and therefore bore a net economic burden of only the amount by which such expenses, $211,470.59, exceeded $183,364.60, or (disregarding the slight and immaterial adjustment) $28,100.66.

rate entity, where two corporations are closely integrated. Although declaring that certain authorities cited by the petitioner presented "peculiar situations", the effect of the decision of the court below, if it represents the law, is that that under no conceivable circumstances may the "agency doctrine" be applied at a taxpayer's instance. Because as to both of these questions the authorities are in conflict and neither question has ever been authoritatively determined by this Court, this petition for review is presented.

JURISDICTION.

This being an application for a review of a final judgment of the Circuit Court of Appeals for the Eighth Circuit, the jurisdiction of this Court is sustained by Section 240 of the Judicial Code, as amended (U. S. Code, Title 28, Section 347), and by Section 1141 of the Internal Revenue Code (U. S. Code, Title 26, Section 1141). The Circuit Court of Appeals had jurisdiction under the second of these sections, namely Section 1141.

The judgment of the Circuit Court of Appeals was entered July 31, 1942 (95). Timely petition for rehearing was filed which was denied September 8, 1942 (103).

Cases believed to sustain the jurisdiction are:

Old Colony Trust Co. v. *Commissioner*, 279 U. S. 716, 49 S. Ct. 499, 73 L. Ed. 918;

Magnum Import Co. v. *Coty*, 262 U. S. 159, 43 S. Ct. 531, 67 L. Ed. 922;

Columbus Watch Co. v. *Robbins*, 148 U. S. 266, 13 S. Ct. 594, 37 L. Ed. 445;

Smith v. *Wilson*, 273 U. S. 388, 47 S. Ct. 385, 71 L. Ed. 699.

QUESTIONS PRESENTED.

The questions presented are:

1. Whether in the case of a payment, pursuant to a contract obligation, and otherwise representing the ordinary and necessary expense of carrying on a taxpayer's business, by the taxpayer corporation to another corporation through which a part of the paying corporation's business is carried on without increased expense, but which is measured by the receiving corporation's deficit in carrying on such operations, is a capital or an ordinary expenditure.

2. Whether the "agency doctrine", so-called, by which under certain circumstances, separate corporate entities may be disregarded (which still is invoked at the instance of the taxing sovereignty), may no longer be invoked, at the instance of the taxpayer, and, accordingly, whether numerous past decisions applying this doctrine in taxpayers' favor no longer represent the law.

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT.

I. As to the first question:

1. The decision of the tribunals below are on this question in conflict with the following cases:

Wiggin v. *Commissioner*, 46 Fed. (2d) 743, (C.C.A. 1);

New York, Chicago and St. Louis R. R. v. *Helvering*, 71 Fed. (2d) 956 (App. D.C.);

Western Maryland Ry. v. *Commissioner*, 33 Fed. (2d) 695, (C.C.A. 4);

New York Central R. R. v. *Commissioner*, 79 Fed. (2d) 247 (C.C.A. 2).

The first two of these cases were included by the court below in a footnote collection of cases, *pro* and *con* (94),

assertedly representing the authorities on the question whether a payment such as was here made is a capital or an ordinary expenditure. A majority of these cases included by the court in this footnote appear to support the result below; some are not in point (which is obviously true of *Welch* v. *Helvering*, 290 U. S. 111, 54 S. Ct. 18, 78 L. Ed. 212, the only decision of this Court included in the collection); and the first two cases listed above are in direct conflict with the result in this case. In the *Wiggin* case the court allowed the principal stockholder of a corporation who paid, under contract, the corporation's losses to deduct such losses as a business expense, as against the contention (identical with that made here) that such payments were capital advances, and notwithstanding an element in that case, not here involved, of tax avoidance. The *New York, Chicago and St. Louis* case was one involving advances in prior years to a lesser railroad by a lessee railroad which owned all the lessor's stock, which advances were held to be operating expenses of the years when made, as against the contention that the accumulated advances were deductible as a loss, or bad debt, in the taxable year.

In the *Western Maryland* and *New York Central* cases a successor corporation was allowed to deduct amortization of discount with respect to bonds of predecessor corporations, as against the contention that the discount suffered was suffered by the predecessor, and insofar as borne by the taxpayer, was part of the capital cost to the taxpayer of the predecessor's assets.[1]

The result below is contrary to the reasoning and dicta in *National Piano Mfg. Co.* v. *Burnet*, 50 Fed. (2d) 310 (App. D.C.) and *All Russian Textile Syndicate Inc.* v. *Commission*, 62 Fed. (2d) 614 (C.C.A. 2).

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[1] This Court denied certiorari in the *New York Central* case, 296 U. S. 653, 56 S. Ct. 370, 80 L. Ed. 465.

A more recent Board of Tax Appeals memorandum decision, by another member than the member deciding the present case, is squarely contrary to the result in the present case, *Shasta Water Co.* v. *Commissioner*, Docket No. 102772, not reported officially but available in the Commerce Clearing House Board of Tax Appeals service as Decision 12411-B[1]. There, on closely similar facts, a parent corporation's payment of a subsidiary's deficit was held deducible as an ordinary and necessary expense, as against the contention that it was not an expense of the taxpayer parent.

While the numerical weight of Circuit Court of Appeals decisions collected by the court below may appear to support the result below, many of these authorities collected are factually distinguishable. Admittedly, as the court below recognized, some authorities hold the opposite. There is no decision of the question by this Court. The decision below is in plain conflict with some of these cases, and especially in the *Wiggin* case.

2. This case involves, on this major point, an important question of Federal law which has not been but should be settled by this Court.

The case of *Welch* v. *Helvering*, 290 U. S. 111, 54 S. Ct. 18, 79 L. Ed. 212, the only one by this Court which is included in the authorities collected by the court below, is so obviously not in point on the question here presented that it is unnecessary to discuss it. It was distinguished by the Board itself in a case stronger on its facts for the Commissioner (*Miller* v. *Commissioner*, 37 B.T.A. 830[2]). It is

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[1] Also in Prentice-Hall B.T.A. Memorandum Decisions, paragraph 42077.

[2] The Commissioner announced his non-acquiescence in this Board decision, 1938-2 Cum. Bul. 51, but never appealed.

obviously of importance in the administration of the Revenue laws, and to business, that there be a settlement of the question whether a corporate taxpayer paying (in the ordinary course of business) a subsidiary's operating deficit, incurred in conducting the taxpayer's business, may deduct that expense from gross income, or whether, on the contrary, it is to be taxed on a net income actually though not legally greater than what is in fact its net income.

II. As to the second major question:

1. The decision of the Circuit Court of Appeals is in conflict with the recent Tenth Circuit decision in *Inland Development Co.* v. *Commissioner*, 120 Fed. (2d) 986.

The decision is also in conflict with the following, among other authorities:

North Jersey Title Insurance Co. v. *Commissioner*, 84 Fed. (2d) 898 (C.C.A. 3);

U. S. v. *Brager Building and Land Corp.*, 124 Fed. (2d) 349 (C.C.A. 4);

Munson Steamship Line v. *Commissioner*, 77 Fed. (2d) 849 (C.C.A. 2);

Western Maryland Ry. v. *Commissioner*, 33 Fed. (2d) 695;

New York Central R. R. v. *Commissioner*, 79 Fed. (2d) 247 (C.C.A. 2), certiorari denied, 296 U. S. 653, 56 S. Ct. 370, 80 L. Ed. 465.

All of the above cases, and others, were cases in which separate corporate entities were disregarded at a taxpayer's instance. They cannot be easily brushed aside as "depending on their own facts". The *Inland Development* case

is squarely contra.[1] So is the *Munson Steamship Line* case. The *North Jersey Title* and *Brager* cases involved situations where the formal separate entity of a corporation holding title to land, organized by and for the benefit of the taxpayer to overcome some legal or practical objection to direct ownership, was disregarded at the taxpayer's instance and income taxes thereby reduced. The view of the law taken in the present case is directly contrary, and appears to foreclose such relief in all cases. If the present decision is right, those cases are wrong. This is emphasized by two very late cases involving the *North Jersey* and *Brager* situation: one decided November 7, 1942, by the Circuit Court of Appeals for the Fifth Circuit, *Commissioner* v. *Moline Properties, Inc.*, not yet reported, but available in the Commerce Clearing House 1942 Federal Tax Service at paragraph 9728, on page 10717; the other, decided November 3, 1942, by the Eighth Circuit Court of Appeals, *Palcar Real Estate Company* v. *Commissioner*, not yet reported but available in the same service, at paragraph 9733, on page 10,728. Both these cases arrive at the same result as that of the decision below and are in harmony with it, but are squarely contrary to the *Inland Development Company, North Jersey Title Company* and *Brager*[2]

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[1] A good discussion of the *Inland Development* and *Brager* cases appears in the Fourth Circuit decision in *American Package Corporation* v. *Commissioner*, 125 Fed. (2d) 413, in which they were distinguished, but recognized as having properly applied the general rule. The conflict between the present case and the *Brager* case is seemingly recognized by the court below in its own footnote reference in its very recent decision in *Palcar Real Estate Company* v. *Commissioner*, decided November 3, 1942, not yet reported but published in the Commerce Clearing House 1942 Federal Tax Service, at paragraph 9733, page 10,728.

[2] The Commissioner did not apply for certiorari in either

cases. The Fifth Circuit cites in support of its result the Eighth Circuit's opinion below, in this very case now before the Court on the present petition. In the *Palcar Real Estate Company* case the Eighth Circuit does the same (by footnote reference) and recognizes that the *Brager* case is contra. The same footnote to the *Palcar Real Estate Company* case says further that it is unnecessary to review the decisions, adding that "some of them appear not to be wholly legally reconcilable on the facts set out in the opinions", thus recognizing the conflict in decisions of the Circuit Courts of Appeals. There is therefore a clear conflict on the fundamental question whether a taxpayer may ever invoke the doctrine of disregard of corporate entity.

2. The Circuit Court of Appeals has decided the present case contrary to three applicable decisions of this Court:

Southern Pacific v. *Lowe*, 247 U. S. 330, 38 S. Ct. 540, 62 L. Ed. 1142;

Gulf Oil Corp. v. *Lewellyn*, 248 U. S. 71, 39 S. Ct. 35, 63 L. Ed. 133;

Weiss v. *Stearn*, 265 U. S. 242, 44 S. Ct. 490, 68 L. Ed. 1001.

No contention is made that these cases resemble the present one on their facts, or that, to borrow the language of the court below (93), they are to "be regarded as laying down any general rule authorizing disregard of corporate entity in respect of taxation". Yet these three cases were all instances in which such separate entity was disregarded to give relief to the taxpayers there involved. Under the doctrine of the decision below, that of the recent Fifth Circuit decision in the *Moline Properties, Inc.* case, and that of the court below in the *Palcar Real Estate Co.*, case, that

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the *Inland Development Company*, *North Jersey Title Company*, or *Brager* cases.

such relief may never be had at taxpayer's instance, the result in those three cases decided earlier by this Court must have been wrong.

3. This case involves an important question of Federal law which has not been but should be settled by this Court.

The law today on the subject of "disregard of corporate entity" is in a hopeless muddle as to the question whether a taxpayer may ever invoke it to obtain tax relief, when he has himself been responsible for the existence of the problem. At one time, following the decision in *Southern Pacific* v. *Lowe* and *Gulf Oil Corporation* v. *Lewellyn*, a considerable body of law was developed, of which the *North Jersey Title* case is a good illustration, which supported the view that although ordinarily the separate entity should be respected, and while it would require much stronger facts evidencing agency in a case where it is the taxpayer that invokes the exception than one where it is invoked against him, yet where the facts are sufficiently strong of a showing that the entity sought to be disregarded was but an agent, or branch or department of another, the substance, not the form will be regarded and relief accorded. This Court did so in *Weiss* v. *Stearn*, 265 U. S. 242, 44 S. Ct. 490, 68 L. Ed. 1001, *supra*.

In the analogous situation arising under the National Bituminous Coal Act, two Circuit Courts of Appeals, the Seventh and Third, have reached diametrically opposite conclusions, in *Consolidated Indiana Coal Co.* v. *National Bituminous Coal Corp.*, 103 Fed. (2d) 124, and *Keystone Mining Co.* v. *Gray*, 120 Fed. (2d) 1, respectively. The arguments for each view are summarized in these opinions. Neither was an income tax case; and it may be that neither is now authoritative since this Court's decision, on a different ground, of the somewhat similar problem in *Powell* v. *Gray*, 314 U. S. 402, 62 S. Ct. 326, 86 L. Ed. Adv. Op. 285; but these cases are illustrative of the conflicting views. The

Seventh Circuit decision rested heavily on *Southern Pacific* v. *Lowe, Gulf Oil Corporation* v. *Lewellyn*, and the *North Jersey Title* case.

This Court, however, in a dictum in *Higgins* v. *Smith*, 308 U. S. 473, 60 S. Ct. 355, 84 L. Ed. 406, suggested that a taxpayer having elected to do business as a corporation must accept the tax disadvantages, and that the Government might look at actualities and might "sustain or disregard the effect of the fiction as best serves the purposes of the tax statute". In the decision, this Court at the Government's instance, and in support of actualities, disregarded the separate corporate entity; but the dictum, treated as an authoritative holding that the taxpayer was in effect estopped ever to invoke the "agency doctrine", has apparently resulted in a noticeable but not unanimous tendency to reject the application of this doctrine in any case where it is the taxpayer that invokes it. Thus the court below, in the present case, and as a reason for ignoring actualities, quoted and followed this Court's dictum in the *Higgins* case. In the *Moline Properties, Inc.* case the Fifth Circuit, ignoring the recent *Brager* and *Inland Development Co.* cases and others to the contrary, cited and purported to follow the *Higgins* case. In the *Palcar Real Estate Company* case the Eighth Circuit says that as its members "read the expressions in *Higgins* v. *Smith*," they "must accept as settled that a corporation which has been conducting business activities as its own, for profit, is not in a position to claim the status of mere nominality for income tax purposes, in order to improve the tax position of its stockholder interests", adding the dictum that "the fact that the corporation may neither have been intended nor used to secure some other tax advantage is quite immaterial." Yet in the *Brager* case, decided after the *Higgins* case (and impossible to reconcile with the *Moline Properties, Inc.* case and now, in the *Palcar Real Estate Company* case, appar-

ently recognized by the court below to be inconsistent with the decision herein) the Fourth Circuit said of the *Higgins* case that "it is going too far to say that if a taxpayer forms a corporation for his convenience he is thereafter estopped from disclosing the true nature of the arrangement whenever it is of advantage to the government to recognize only the corporate form." The judges of that court, referring to the fact that the contrary had been held in many decisions, added that they "do not understand that this body of the law has now for practical purposes ceased to exist". The question here presented is therefore whether that body of law has "for practical purposes ceased to exist". Stated differently, does the dictum in *Higgins* v. *Smith* overrule *Southern Pacific* v. *Lowe*, *Gulf Oil Corporation* v. *Lewellyn*, and *Weiss* v. *Stearn*, and does it express this Court's disapproval of the *North Jersey Title*, *Brager*, *Inland Development Company*, and similar cases, and its approval of the *Moline Properties, Inc.* and *Palcar Real Estate Company* cases, and the rule applied below in the present case? If it is still the law that a taxpayer is not estopped from ever invoking the "agency doctrine", then the law is as it was, and each case turns to some extent on its own facts, just as is still the case in converse situations. If, however, there is such an estoppel, then it is submitted that the point should be made clear by this Court, so that the lower Federal courts and the profession generally may know that the older body of law has been superseded and can no longer be relied on, so that any further attempts by taxpayers to invoke the doctrine may be discouraged. The existing uncertainty and the importance of this question make this case an appropriate one for determination by this Court.

CONCLUSION.

WHEREFORE, your petitioner respectfully prays that a writ of certiorari be issued out of and under the seal of this Honorable Court, directed to the United States Circuit Court of Appeals for the Eighth Circuit, commanding that Court to certify and send to this court for its review and determination, on a day to be therein named, a full and complete transcript of the record and all proceedings in this case numbered and entitled on its docket as Number 12247, *Interstate Transit Lines* v. *Commissioner of Internal Revenue*, and that the decision of the United States Board of Tax Appeals and the judgment of the United States Circuit Court of Appeals for the Eighth Circuit be reversed by this Honorable Court, and that your petitioner may have such other and further relief in the premises as to this Court may seem proper.

Dated at Chicago, Illinois, November 24, 1942.

Respectfully submitted,

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(NOTE: Since the legal propositions upon which petitioner relies have been discussed sufficiently in the foregoing petition, petitioner refrains, in the interest of brevity from appending a brief.)

APPENDIX.

Section 23(a) of the Revenue Act of 1936 provides: "In computing net income there shall be allowed as deductions: (a) Expenses — All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *"

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IN THE

Supreme Court of The United States

No. 552.

INTERSTATE TRANSIT LINES,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI
To The United States Circuit Court of Appeals
For the Eighth Circuit.

BRIEF OF PETITIONER IN REPLY TO RESPONDENT'S BRIEF IN OPPOSITION.

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IN THE

Supreme Court of The United States

OCTOBER TERM, 1942.

No. 552.

INTERSTATE TRANSIT LINES,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI
To The United States Circuit Court of Appeals
For the Eighth Circuit.

BRIEF OF PETITIONER IN REPLY TO RESPONDENT'S BRIEF IN OPPOSITION.

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

Respondent asserts (Brief p. 5) that this case turns on its own facts and presents no conflict. This assertion ignores the announced views of the court below, both in the present case and in its recent decision in *Palcar Real Estate Company* v. *Commissioner*, decided November 3, 1942, not yet reported but available in the Commerce Clearing House Federal Tax Service at paragraph 9733, on page

10,728. The Eighth Circuit Court of Appeals has in these cases held that a corporate taxpayer may never, to reduce its tax liability, invoke the doctrine that a subsidiary is but its agent or *alter ego*. The Fifth Circuit Court of Appeals, in the *Moline Properties, Inc.* case, decided November 7, 1942, not yet reported but available in the Commerce Clearing House Service at paragraph 9728 on page 10,717, reached the same conclusion (reversing the Board's decision reported at 45 B.T.A. 647). The Second Circuit Court of Appeals made a like holding in *Watson* v. *Commissioner*, 124 Fed. (2d) 437. All four cases are bottomed on this Court's dictum in *Higgins* v. *Smith*, 308 U. S. 473, 60 S. Ct. 355, 84 L. Ed. 406; but the Fourth Circuit Court of Appeals in the *Brager* case, 124 Fed. (2d) 349, did not so regard the effect of *Higgins* v. *Smith*, and held the exact opposite. Also, the Tenth Circuit Court of Appeals in the *Inland Development Company* case, 120 Fed. (2d) 986, reached the contrary conclusion and cited *Higgins* v. *Smith* in support of the application of the "agency" doctrine in favor of the taxpayer. Thus, even if earlier decisions prior to *Higgins* v. *Smith* supporting the present taxpayer are disregarded, there are now six Circuit Court of Appeals decisions, including the present case, by five Circuit Courts of Appeals, which have been handed down since the decision in *Higgins* v. *Smith*. In four of them, decided by the Second, Fifth and Eighth Circuits, taxpayers have been told that they may never invoke the "agency" doctrine, and that the doctrine, under which the corporate entities are disregarded, is available in tax cases only to the government. (In the present case the Court below assumed that the subsidiary was in fact an agent of the taxpayer, a necessary assumption in view of the government's admission in the pleadings. Rec. p. 15, par. V, 2.) In the Fourth and Tenth Circuits the contrary is the rule, and in them the taxpayer may, if the facts warrant it, invoke the doc-

trine. The present application does not, therefore, as respondent asserts, involve merely fact questions.[1] The Court below, in its opinion, assumed that the subsidiary was the taxpayer's agent (Rec. p. 92). The unsettled question of law remains whether, assuming such agency to exist, the benefit of the agency doctrine can ever avail the taxpayer when it is the taxpayer, not the government, that invokes the doctrine. On this point the cases are in irreconcilable conflict.

Respondent himself mentions (Brief pp. 8, 9) three of the cases, the *Brager*, *Watson* and *Moline Properties, Inc.* decisions, although he ignores the hopeless conflict between the *Brager* and the other two cases, and, instead, suggests a shadowy distinction from the former, and cites the two latter cases in support of his argument. A comparison of the Board's findings and opinion in the *Moline Properties, Inc.* case, 45 B.T.A. 647, with the Fifth Circuit opinion reversing the Board emphasizes the length to which that and the Second and Eighth Circuit Courts of Appeals appear to have gone in assumed obedience to the *Higgins* v. *Smith* dictum. That the question presented is one of law, not of fact, is emphasized by the Fifth Circuit's refusal to accept the Board's conclusion, based on facts, to the effect that the case fell within the Board's holdings wherein it had "disregarded the corporate entity to effect a more realistic assessment of taxes." 45 B.T.A. 647. The Commissioner's

[1] In furtherance of this assertion, respondent has referred (Brief p. 4) to the mechanics of the accounting. In the petition herein it was pointed out (on page 2) that this subject was not relevant to the present application. It played no part in the decision below, for aught that appears in the court's opinion. Suffice it to say that during 1936 the present taxpayer in fact "paid or incurred" the expenses producing the deficit, and therefore "paid or incurred" the deficit.

brief on file in the Fifth Circuit in the *Moline Properties, Inc.* case (number 10,279 on the Fifth Circuit's docket) treats the question as one entirely of law, builds the argument for reversal entirely on *Higgins* v. *Smith*, and grudgingly recognizes an inconsistency with the *Inland Development Company* and *Brager* cases, in the latter of which he admits that the court "rejected the generality of the principle laid down in *Higgins* v. *Smith*" that the taxpayer employing a corporation "may not disavow it but must accept such tax disadvantages as may result." The Commissioner then, in his brief, admitted that this Court's statement in *Higgins* v. *Smith* "was perhaps beyond the necessities of the immediate issue in the case," but argues that it was deliberate as a warning "against an interpretation of the holding that would lead taxpayers to urge the case as authority in situations where it would be to their advantage to urge non-recognition of their chosen forms of doing business." Yet the Tenth Circuit Court of Appeals in the *Inland Development Company* case did so interpret the holding in support of its decision in favor of the taxpayer.

The fact is that the law on this subject is now in a hopeless muddle that cannot be resolved unless by a decision of this Court holding either, with the Second, Fifth and Eighth Circuits, that the doctrine may never be invoked by a taxpayer, or, with the Fourth and Tenth Circuits, that a taxpayer may invoke it where the facts warrant and that each case depends on its own facts.

Respondent's "Statement" and factual references in his argument convey the impression that the deduction here claimed arose from intra-state business which, respondent says (Brief p. 5), taxpayer "lacked legal ca-

pacity" to perform,[1] wherefore, says respondent (Brief pp. 5, 6), the deficit was not incurred in taxpayer's business. Thus does respondent, seeking to have this case treated as one merely turning "upon its own facts" (Brief p. 5), brush lightly over his own express admission in his pleading that taxpayer was in 1936 engaged in inter-state transportation of passengers between Chicago and Los Angeles (Rec. p. 15); and also avoid the lower Court's own assumption that the subsidiary was an agent of the petitioner as a carrier of its inter-state traffic in California (Rec. p. 92). The opinion below concedes, *arguendo*, the fact of agency, but treats this fact as of no consequence. Yet it was because of the subsidiary's agency for it in the conduct of its business as an inter-state carrier of passengers that the taxpayer bore the subsidiary's deficit.

On the question whether a corporation which in the course of its business assumes another's deficit, pursuant to contract, may deduct the amount thereof as a business expense, respondent's attempted distinction of the *New York, Chicago and St. Louis* case, 71 Fed. (2d) 956 (App. D. C.) (Brief p. 6), and the *Wiggin* case, 46 Fed. (2) 743, (C.C.A. 1) (Brief pp. 5, 6), is not in accordance with the express recognition by the Court below (Rec. p. 94 and footnote) that there was not a "unanimity of decision," and that these two cases at least are not in accordance with the present decision. Of the *Wiggin* case respondent says (Brief p. 6) that the Court there "construed the contract to attribute the losses to the contracting individual and accordingly allowed him the corresponding deduction." Just why that language is not equally applicable here is not apparent. In that case the contract,

[1] This statement is incorrect as applied to 1936. This subject is explained fully on pages 3 and 4, and in the footnote, of the petition herein.

made between a corporation and its main stockholder, provided for the latter's employment by the former with the understanding that his compensation should be the corporation's net profits for two years, and that he should pay all losses incurred by the corporation for the same period, and that in case of loss he had the option to extend the period of the agreement. Under this agreement he paid large losses of the corporation from 1922 to 1925, inclusive, which he claimed as business expense deductions for those years. Upon the express ground that the corporation's business "was not the business of the taxpayer" the Board of Tax Appeals refused to sanction these deductions (19 B.T.A. 282). The First Circuit reversed, holding that the corporation's losses were the taxpayer's losses, "practically and legally, as much as if he had taken over the business and run it in his own name." The Court also said that the losses were deductible as "incurred in any transaction entered into for profit," which, notwithstanding respondent's intimation (Brief p. 6) that this suggested alternative ground for decision also distinguishes the case, would also support the claimed deduction in the present case. It is simply impossible to reconcile the *Wiggin* case with the decision below, and the Court below apparently recognizes that this is the case (Rec. p. 94 and footnote). The point involved in both cases has never been decided by this Court. The only two cases decided by this Court which respondent cites on this point (Brief p. 5), *New Colonial Ice Company* v. *Helvering*, 292 U. S. 435, 54 S. Ct. 788, 78 L. Ed. 1348, and *Deputy* v. *DuPont*, 308 U. S. 488, 60 S. Ct. 363, 84 L. Ed. 416, do not decide the legal question here involved. The *New Colonial Ice Company* case is no wise in point. The *Deputy* case involved a single extraordinary and unusual transaction of considerable magnitude of an individual stockholder of a large corporation who owned only sixteen

per cent of its stock, and the transaction, although undertaken by him, was to assist the corporation in its business relations with its officers; whereas here the expenses which produced the deficit were incurred in the ordinary, regular course of the taxpayer's own inter-state business, conducted through its agent, the subsidiary. The legal question whether under such circumstances the payment pursuant to contract of the deficit of the agent is a business expense or a capital payment is one on which the Circuit Courts of Appeals are not in agreement, as the Court below itself points out (Rec. p. 94 and footnote). The First Circuit in the *Wiggins* case has decided this question contrary to the decision below. Some other decisions collected by the Court below (Rec. p. 94 and footnote) are also contrary.

Dated at Chicago, Illinois, December 23, 1942.

Respectfully submitted,

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IN THE

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SUPPLEMENTAL BRIEF OF PETITIONER.

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McCORMICK AND HENDERSON, INC., CHICAGO

IN THE

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INTERSTATE TRANSIT LINES,
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SUPPLEMENTAL BRIEF OF PETITIONER.

In amplification of what appears on page 4 of the petitioner's reply brief herein, and to present fully and fairly the Commissioner's interpretation of this Court's opinion in *Higgins* v. *Smith*, 308 U. S. 473, 60 S. Ct. 355, 84 L. Ed. 406, there are herewith supplied excerpts from the brief of the Commissioner of Internal Revenue in *Commissioner* v. *Moline Properties, Inc.*, Docket No. 10279, Fifth Circuit Court of Appeals, on file with Clerk of that Court.

On pages 18 to 23, inclusive, of said brief appears the following:

> "While some of the decisions in the Circuit Courts of Appeals since *Higgins v. Smith* do not entirely con-

form to its doctrinal enunciation, the over-all picture is one of considerable uniformity. In the Tenth Circuit two decisions adhere closely to the doctrine. Another, with a superficial semblance of departure, represents a situation of extraordinary circumstances which in the opinion of the court warranted an exception. Thus, in *Continental Oil Co.* v. *Jones*, 113 F. 2d 557, certiorari denied, 311 U. S. 687, the Tenth Circuit, at the behest of the Government, refused to countenance the validity of certain sales from a parent company to its subsidiaries where the sales were unprecedented in character and amount, no provision was made for predictable payment, and in addition to other circumstances showing that the sales were shams, their purpose was solely to avoid the payment of excise taxes. In *Texas-Empire Pipe Line Co.* v. *Commissioner*, 127 F. 2d 220 (C. C. A. 10th), presenting the converse aspect of the *Higgins* v. *Smith* doctrine, the court denied the taxpayer's contention that the corporate entities of the parent and subsidiary companies should be disregarded and the latter treated as a mere instrumentality of the former. The court found that the subsidiary served two legitimate business purposes, and said (p. 224):

> Having elected to organize the subsidiary to serve legitimate business purposes, the parent must accept the attendant tax disadvantages.

Higgins v. *Smith* and *Burnet* v. *Commonwealth Improvement Co.*, *supra*, were cited in support of this statement. In the earlier case of *Inland Development Co.* v. *Commissioner*, 120 F. 2d 986 (C. C. A. 10th), the court had held that the identity of several subsidiary companies would be disregarded at the behest of the taxpayer-parent corporation. The consequence of treating the subsidiaries as separate corporations would have been to subject the parent to the greater tax imposed upon personal holding companies, by reason of the fact that the bulk of the parent company's income

during the taxable year consisted of an alleged dividend distribution from a subsidiary company. Actually, viewing this specific transaction — the dividend — the subsidiary had no accumulated surplus nor money on hand from which a dividend distribution could have been made. Most important, and this was the ground on which the *Texas-Empire* decision *supra*, distinguished this case, there was no apparent motive or purpose served by the creation of subsidiaries. Whether or not the *Inland* case was correctly decided, in light of the principle of *Higgins* v. *Smith* that the taxpayer may not disavow the form that he chooses for doing business, it is distinguishable from the case *sub judice*, where the corporation was created to serve a definite purpose. Indeed, that purpose, *viz.*, the profitable conclusion of the real estate venture, was so well served that it forms the basis of the controversy here.

United States v. *Brager Building & Land Corp.*, 124 F. 2d 349 (C. C. A. 4th), is distinguishable in at least two respects. Unlike the present corporation, the taxpayer there did not assume the mortgage debt against the property transferred to it. In addition, the court considered (p. 350) that there was—

> little or no distinction in actuality between the corporation and the holders of its stock.

Here, a similar conclusion would fly in the face of the very purpose for which the taxpayer was created. *Cf. Sheldon Bldg. Corp.* v. *Commissioner*, 118 F. 2d 835, 836 (C. C. A. 7th), rehearing denied April 15, 1941. It must be recognized that the court in the *Brager* case rejected the generality of the principle laid down in *Higgins* v. *Smith*, *supra*, that when a taxpayer for reasons satisfactory to himself voluntarily chooses to employ a corporation in his operations, he may not disavow it but must accept such tax disadvantages as may result. This principle was stated by the Supreme Court deliberately and without qualification. The

enunciation of the principle was perhaps beyond the necessities of the immediate issue in the case. As such, its very deliberation and lack of qualification achieve even greater significance than otherwise might be the case. For its apparent purpose was a *caveat* against an interpretation of the holding that would lead taxpayers to urge the case as authority in situations where it would be to their advantage to urge nonrecognition of their chosen forms of doing business. The language of the *Brager* case (p. 351) might lead to the supposition that the Government there was affirmatively and arbitrarily taking the stand that a sham arrangement had to be recognized because it was to the advantage of the revenue. While such a stand requires no apology in the light of the express language of *Higgins* v. *Smith*, the court's emphasis was tangential. Actually, the situation was one in which the taxpayer, a deliberately chosen entity, was urging that it was no entity at all. So long as no tax problem arose it would have the world respect its identity. Upon the death of the surviving partner (its sponsor), it would assert its individuality "to avoid complications" (p. 350). But once it became apparent that a tax saving would result by virtue of merging its taxable income with the individual items of its sponsor, it proceeded to disavow itself. The Government simply took the corporation as it found it and as the corporation would have had the entire world, with the exception of the tax collector, find it. It is difficult to perceive anything arbitrary in that position of the Government.

Lyon, Inc., v. *Commissioner*, 127 F. 2d 210, 212-213 (C. C. A. 6th), is not authority against the Commissioner here. It did not involve an attempt by the taxpayer to have the corporate entity disregarded. The question discussed by the court was whether a transaction which could not under the law be a reorganization might, at the option of the Government, be treated as such for the purpose of imposing a tax.

The principles of *Higgins* v. *Smith*, quoted above, have been followed in these cases: *Helvering* v. *Jane*

Holding Corp., 109 F. 2d 933, 943 (C. C. A. 8th), rehearing denied March 16, 1940, certiorari denied, 310 U. S. 653, rehearing denied, 311 U. S. 725; *Mead Corp.* v. *Commissioner*, 116 F. 2d 187 (C. C. A. 3d); *Mehrlust* v. *Higgins*, 112 F. 2d 717 (C. C. A. 2d); *Brown* v. *Commissioner*, 115 F. 2d 337 (C. C. A. 2d); *Watson* v. *Commissioner*, 126 F. 2d 203 (C. C. A. 2d); *Vim Securities Corp.* v. *Commissioner* (C. C. A. 2d), decided July 21, 1942 (1942 C. C. H., par. 9602; *Interstate Transit Lines* v. *Commissioner* (C. C. A. 8th), decided July 31, 1942 (1942 C. C. H., par. 9618). *Cf. Commissioner* v. *Laughton*, 113 F. 2d 103 (C. C. A. 9th).

In *Watson* v. *Commissioner*, *supra*, the taxpayer sought to deduct the losses of two corporations which he had created and which nominally published two magazines. In general, the corporate entities were disregarded and the taxpayer, who was the sole beneficial owner of the stock, managed the business operations as if he were individually the publisher. All financing was done on his personal credit. He provided the funds needed by the corporations, paid their obligations and endorsed their notes. He never received any evidences of indebtedness from the companies for his expenditures. The court denied the deduction. It held that *Higgins* v. *Smith*, *supra*, militated against the taxpayer, saying (p. 439):

> Having chosen the corporate form he cannot complain that he is held to it by the taxing officials.

The contention that the corporations were neither formed nor availed of to secure a tax advantage was held to be irrelevant.

Interstate Transit Lines v. *Commissioner*, *supra*, involved a parent and its subsidiary corporation. The parent claimed that it was entitled to deduct the loss of the subsidiary. The subsidiary agreed to operate busses upon such routes and schedules and under such rules and regulations as the parent should direct. The latter was to make good any deficit of the former,

which in turn was to pay over all its profits to the parent. Both companies had the same officers and directors. While the subsidiary had its own records, they were kept at the parent's office by the parent's employees. The parent collected all the revenues of the subsidiary and paid all its bills. The subsidiary had no separate bank account. A definite purpose was served by the creation of the subsidiary. The court relied on *Higgins* v. *Smith*, *supra*, to reach the conclusion that the corporate entity of the subsidiary could not be disregarded, nor the tax disadvantage resulting from its organization avoided.

The prior decisions of the Board which are the reliance of the opinion below failed to analyze the problem in the light of the principles of *Higgins* v. *Smith*. We submit that the doctrine of that case and the preponderance of authority require rejection of the taxpayer's attempt to disavow its own existence in order to avoid a tax disadvantage resulting from its creation."

Copy of Attorney General's letter to Clerk of the Circuit Court of Appeals for the Fifth Circuit in *Commissioner* v. *Moline Properties, Inc.*, Docket No. 10279 in that Court, in response to taxpayer's petition for rehearing filed therein November 28, 1942 is as follows:

"SOC" BMB:fs
5-7069

December 7, 1942

Oakley F. Dodd, Clerk
United States Circuit Court of Appeals
for the Fifth Circuit
New Orleans, Louisiana

Re: *Commissioner* v. *Moline Properties, Inc.*
No. 10279

Sir:

A copy of the taxpayer's petition for rehearing, filed on November 28, 1942, has been received. Because the

matters therein stated were fully discussed in the briefs of the parties and in the argument before the Court, and add nothing new to be considered, this office does not propose, unless request should be made by the Court, to file a formal reply.

The substance of the petition appears to be that this Court has unjustifiably reversed a decision of the Board on a question of fact. Actually, however, the decision of this Court was that the Board had erred in its application of legal principles to the facts before it. The taxpayer also complains (Pet. 4) that there is nothing in the record or the Board's findings to show that the form employed for doing business was unreal or a sham. Presumably, the absence of such evidence and such a finding tends to sustain the Commissioner's position. The question here was not whether a given transaction, such as a sale from a stockholder to his corporation, was a reality or a sham, but whether a voluntarily-selected form for carrying on a business could be disavowed when a tax saving might result.

Respectfully,

For the Attorney General,
SAMUEL O. CLARK, JR.,
Assistant Attorney General."

CC: R. H. Eyles,
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Congress Building,
Miami, Florida

The Prentice Hall organization, one of the two standard recognized "services" on the subject of taxation, had the following comment in a recent "What's Happening" release (of November 28, 1942):

"DISREGARDING CORPORATE ENTITY

Can the corporate form be disregarded in determining tax consequences of operations of property held

by corporation? Question often arises in connection with "dummy" real estate corporations. Sole stockholder claims he and corporation are one and the same. Hence, he argues, no tax should be imposed on corporation; its income or loss should be treated as his individual income or loss.

BTA has upheld argument in many cases. Recently, Fourth Circuit ruled likewise in a well considered opinion (*U. S. v. Brager*, 124 Fed. (2d) 349). More recently, Second and Fifth Circuits have held to the contrary: *Watson* case from 2nd Circuit (124 Fed. (2d) 437), holding sole stockholder could not deduct corporation's operating loss; *Moline* case from 5th Circuit (11/7/42) holding income taxable to corporation and not to its sole stockholder.

OBSERVATION 1 Conflict among Circuits indicates possibility that question may be settled soon by Supreme Court. Meanwhile those concerned (both stockholder and corporation) should take appropriate steps to insure refunds in event of favorable decision.

OBSERVATION 2 It is settled that the *government* may disregard the corporate entity when used to commit fraud, or for tax evasion purposes (*Higgins v. Smith*, 308 U. S. 473)."

While the present application is not a real estate case, the view of law taken herein of the opinion below is the same as that adopted by the Fifth Circuit in its opinion reversing the *Moline Properties, Inc.*, case. The Commissioner relied heavily on the decision below herein and the

Court followed it as an authority. The conflict with the *Brager* opinion, 124 F. (2d) 349, is plain, and appears to have been recognized even by the Commissioner himself.

Respectfully submitted,

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Respondent.

ON WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

PETITIONER'S BRIEF.

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To the Honorable Chief Justice and Associate Justices of the United States Supreme Court:

OPINIONS BELOW.

The opinion of the Board of Tax Appeals is reported at 44 B. T. A. 957. The opinion of the Circuit Court of Appeals is reported at 130 Fed. (2d) 136.

JURISDICTION.

This case is here upon a writ of certiorari which was granted March 8, 1943, to review the decision of the Circuit Court of Appeals for the Eighth Circuit, entered July 31, 1942, affirming the decision of the Board of Tax Appeals in an income tax case involving the taxable year 1936, in which the Board sustained a deficiency determined for that year by the respondent. The jurisdiction of this Court is sustained by Section 240 of the Judicial Code, as amended (U. S. Code, Title 28, Section 347) and by Section 1141 of the Internal Revenue Code (U. S. Code, Title 26, Section 1141). The Circuit Court of Appeals had jurisdiction under the second of these sections, namely, Section 1141.

STATEMENT OF THE CASE.

(Numerals in Parentheses refer to pages of the printed record.)

Respondent determined a deficiency of $4,461.53 in petitioner's 1936 income tax. The Board of Tax Appeals, in a decision rendered July 9, 1941 (19), upheld the Commissioner. The Circuit Court of Appeals for the Eighth Circuit affirmed the Board (78). 130 Fed. [2d] 136. Certiorari was granted March 8, 1943, to review that decision.

The deficiency is predicated upon the disallowance of a deduction claimed by taxpayer of $28,100.66, the amount by which 1936 expenses allocated to taxpayer's subsidiary, Union Pacific Stages of California (herein referred to as "Stages"), exceeded its allocated receipts. Petitioner, the taxpayer (herein sometimes referred to as "Interstate"), actually, and without any offsetting benefit or consideration other than Stages' nominal conduct of taxpayer's California business operations, bore the economic burden of this operating deficit, no part of which represented any advance for capital purposes (41). A formal contract,

between the two companies, entered into in 1932, required Interstate to assume this deficit. The Commissioner disallowed the deduction on the ground that "no provision of the Revenue Act of 1936 authorizes such deduction" (8). Taxpayer claims the right to the deduction under Section 23(a) of the Revenue Act of 1936, 48 St. L. 1658, as an "ordinary and necessary expense" of carrying on its business.

The facts are not in dispute. The taxpayer is a Nebraska corporation organized in 1929 and engaged in transcontinental bus transportation between Chicago and the Pacific Coast. The answer admits (13) that taxpayer during the year 1936 was engaged in the operation of motor buses for the transportation of passengers between Chicago and Los Angeles. After 1932 and throughout 1936 the portion of each bus trip between the California line and Los Angeles, although actually a part of Interstate's operation, was nominally operated by taxpayer's subsidiary, Stages, under the arrangement hereinafter described, which the petitioner claims created the relation of agency between the two companies. After this arrangement was made, intrastate passengers were also carried, which had not theretofore been the case. The Circuit Court of Appeals assumed, (130 Fed. [2d] 136, at p. 139, Rec. p. 75) that Stages was taxpayer's agent as to the interstate portion of the business. The intrastate business was but a fraction of the total business done in California. Revenues allocated to the California business, interstate and intrastate, amounted in 1936 to $183,365.60 (Respondent's Exhibit C, Rec. pp. 45, 66, 67). Expenses allocated to such business, all of which were actually paid by Interstate, amounted to $211,470.59 (*ibid*). This latter figure is what it cost, according to the allocation to the California operation, to carry on (through Stages' nominal agency) the

California portion of the interstate operation[1], in which respondent's pleading admits taxpayer was engaged. It cost no more to handle the few intrastate passengers whose fares, only about $10,000 in all (34), are reflected in the total revenue figure[2]; the Board found (16) that no additional expense was thereby incurred, except the cost of keeping separate accounts (represented by account books and ink and the time necessary to make the book entries, 42); and the Court below accepted "the theory that the expense of carrying intra-California traffic may be disregarded as insignificant" (75). The difference between these two figures of revenues and expenses, $183,365.60 and $211,470.59, respectively, represents (except for a minor and immaterial adjustment) the item of $28,100.66 in controversy. This net deduction is claimed as an ordinary and necessary expense of carrying on petitioner's business.

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[1] The Board's opinion in this respect (18) is not supported by the evidence nor consistent with the Board's own findings (16). The Circuit Court of Appeals accepted the above statement as a fact (75).

[2] The findings are silent as to the treatment of intrastate revenues. Hall, the Auditor, testified that they were assigned direct to Stages. Haugh, the Vice President, who "never paid any attention * * * to the California company because those (expenses and revenues) were absorbed by this agreement by the earnings of the parent company" (36), testified (24) that the management "estimated at the time (of going into the California operation) that there would be about $10,000 added to the revenue by reason of intrastate business." He added that "although we have never kept the accounts separate as to revenue from the intrastate business and interstate business, it probably exceeds that amount and did in 1936." Haugh was evidently mistaken as to failure to segregate interstate and intrastate revenues.

The immediate occasion for using the subsidiary, Stages, was the attitude of the California Railroad Commission toward the conduct by a corporation foreign to that state of an intrastate passenger bus business. Although unable to prevent taxpayer from conducting interstate operations between California points and places outside of California, the Commission had a settled policy of refusing to issue to a foreign corporation a certificate of convenience and necessity to conduct intrastate bus operations. As to years prior to 1936 it is most doubtful whether the Commission correctly construed the California law.[1] By 1936 a California statute, passed in 1935, affirmatively provided that foreign corporations engaged in interstate commerce might transact within the state "such commerce and intrastate commerce of like character".[2] Whether or not the Commission was correct, its attitude appeared, in years prior to 1935, to make it impossible or at least difficult for Interstate itself to carry intrastate passengers in California, a right it had in other states. Being desirous to secure that traffic and add the revenue therefrom to its interstate revenue (34) and thus obtain additional passengers for vacant seats in its through buses without having to incur additional expenses (35), taxpayer for this purpose in 1930 organized Stages under the California laws. By 1932 Stages had, with the State Commission's approval, secured the franchise necessary for intrastate operation (15). Interstate furnished all Stages' capital[3] and recevied all its stock (*ibid*). (No part of this capital investment is in any way involved in the present proceeding.)

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[1] The relevant statutes are set out in the appendix, and are discussed, *infra*, p. 58.

[2] See Appendix, *infra*, p. 63.

[3] With which two buses were purchased, *infra*, p. 6, footnote.

Formal contracts, dated February 7, and 8, 1932 (respectively referred to as the "absorption" and "operating" agreements) were executed by parent and subsidiary. Neither contract was suggested by or involved any element of tax avoidance, or at the time had any tax significance, one way or the other, because the companies then filed consolidated returns. The "absorption" contract recited among other things that Stages was maintained as an operating subsidiary of taxpayer and that its operations were conducted solely for Interstate's benefit; that in order that the latter might obtain the greatest benefit it was necessary that Stages' schedules be coordinated with Interstate's and that Stages operate on such routes and upon such schedules as would most greatly benefit Interstate, and that such operation might not be so remunerative to Stages as operation solely for its own corporate benefit. It was therefore provided, among other things, that Interstate would "assume and reimburse the California corporation for any deficits incurred by the California corporation in its operations" (Petitioner's Exhibit 1, 34, 57).

The "operating" agreement provided, in substance, that buses of Interstate (which had theretofore operated its buses through to Los Angeles) should on each trip continue through, but at the State Line should pass into Stages' custody and that Stages' buses[1], traveling northward, were at the State line to pass into Interstate's custody. Each party leased its buses to the other, while thus in the other's custody, for five cents per bus mile while in such custody, the lessee in such instance to bear expenses (other than drivers' wages and taxes) and insur-

[1] Two buses were bought in 1932, nominally by Stages, with capital funds contributed by Interstate (31). These were "operated in a pool with the parent company's buses" (36).

ance properly attributable to the buses while in its possession. Drivers were to be the employes of and their wages paid by the lessee while in service in connection with leased buses, the effect of which was to make drivers the formal employes of Stages while in California and of Interstate when outside of California. (All drivers were actually paid by Interstate, *infra*, p. 8). Each party was to pay taxes on its own buses (Petitioner's Exhibit 2, 34, 58-60).

After this arrangement was made, the California local business (revenue from which, as already stated, was in 1936 only about $10,000) (34) was handled without additional expense in the same buses previously operated by Interstate (35). There were the same schedules and no physical changes whatever. The only change was in bookkeeping. There was no breach in the operation of buses or change of passengers at the State line. The expenses which produced the deficit represented the expense of conducting the interstate operation, as the Court below correctly assumed.

In harmony with the California Commission's interpretation of the local law, the local franchises from the Nevada-California State line westward were obtained in the name of Stages (33). Prior to the organization of Stages and the time when intrastate passengers were carried, Interstate had already secured a bus terminal in Los Angeles (35). After Stages was formed, the Los Angeles bus terminal, which was held under a lease, was transferred to Stages, and in 1936 the lease "stood in the name of the California Company" (35). There was also a lease covering a garage at Los Angeles that was taken out in the name of Interstate, which when Stages was formed was transferred to it (*ibid*). Bus depots in California and agencies for the sale of tickets had been opened by Inter-

state for the interstate business (*ibid*). After Stages was organized, the same agencies that had sold Interstate tickets became also the agencies for intrastate tickets (*ibid*). This is the extent of Stages' relations with third persons disclosed by the record. Even the dealing as to these relations was with Interstate only.[1]

Interstate and Stages had the same officers and directors (16). Stages' accounting records, though kept separately, were kept at taxpayer's office and by taxpayer's officers and employees (*ibid*). Stages never had any bank account (*ibid*). Its revenue and expenses were handled by taxpayer (*ibid*), which was Stages' banker (55). It had no pay-roll (40). Employes below the classification of general officers, whose salaries were apportioned on the books (*ibid*), who participated in the conduct of the California business, were carried only on Interstate's payrolls and paid by Interstate vouchers, without segregation for services performed in California (*ibid*). Interstate collected all Stages' revenue and paid all bills, payrolls and otherwise (16, 40, 41).

While in a very limited sense it is literally true, as recited in the findings (16), that Stages had its own accounting records, employes, buses, directors and corporate minute book, yet all employes of both companies were carried on Interstate payrolls and for all services performed,

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[1] Answers of the witness Haugh, Interstate's Vice President, to leading questions on cross-examination were to the effect that Stages was "doing business," "selling tickets," and "had buses running on the roads" (38). These answers, by way of conclusion, which were put by counsel into the mouth of the witness, do not change the objective fact that Stages had no bank account, that Interstate collected all revenues and paid all expenses, and that the extent of Stages' relations with third persons was that stated in the text above.

whether nominally for Interstate or Stages, were paid by Interstate checks (40). Payroll payments with respect to California operations were apportioned on a revenue motor coach mile basis (40). The findings do recite that taxpayer "paid all of the bills, payroll and otherwise, of Stages" (16).

Revenues, which were collected and retained by Interstate, were allocated on the books by assigning California intrastate revenue directly to Stages (40), and assigning interstate California revenue on a passenger mile basis (16, 40). As already mentioned, revenues thus allocated to Stages in 1936 were $183,365.60, and expenses, so allocated in the same year, were $211,470.59. The correctness of these figures is not disputed. Interstate collected, retained, and had the economic benefit of the $183,365.60 of revenues allocated to Stages (which included the $10,000 of intrastate fares). It also actually bore the economic burden of the expenses allocated to Stages, $211,470.59, which it paid out of its own funds. Interstate would have been compelled to pay these same expense items had there been no intrastate passengers. Interstate, therefore, under the contractual arrangement with its subsidiary, bore the net economic burden represented by the difference in these figures of revenue and expenses, which (disregarding the slight and immaterial adjustment already mentioned) was $28,100.66.

The books of both Interstate and Stages, the latter being kept by Interstate, were on the accrual basis (17). Although there were no money transactions between parent and subsidiary, the subsidiary not having any funds of its own, nor any bank account, all revenues being collected and retained by Interstate and all expenses being paid by

Interstate, yet these accounts contained entries of various inter-company items, including Interstate's allocation as between it and Stages of revenues and expenses, records of cash advances by Interstate with respect to the California operations, and inter-company obligations to one another (compare Petitioner's Exhibits 3 and 4, 43, 44, 61, 62; Hall's testimony, 40-44; 46-48; Respondent's Exhibits A, B and C, 45, 63-67). The mechanics of accounting for the item here involved, the deficit of $28,100.60, are briefly summarized in the findings (16, 17) and covered in some detail by the testimony. The effect of the accounting was that an indebtedness, in form, from Stages to Interstate of some $34,000 was reduced by the application against it of the deficit, which the "absorption" contract required Interstate to assume, so that after application of this amount, the formal indebtedness was reduced to approximately $5,000 (17). The Board of Tax Appeals expressly refrained from passing upon accounting questions incident to the mechanics used; and the subject is only briefly referred to in the opinion of the court below (73). This aspect of the matter is unimportant to a consideration of the questions of law presented for review. Suffice it to say that Interstate made the disbursements for the operating expenses, received the revenues, and actually bore the economic burden of the deficit.

The Board of Tax Appeals decided the case adversely to Interstate upon the ground that the deduction claimed was not an ordinary and necessary expense of its business. The opinion (17-19) recites that the business of Stages was performing intrastate transportation within California, which, it is said, could not have been the taxpayer's business. Stages was said to have been organized not to increase the profits of the taxpayer's business, but to augment its income by increasing Stages' income from intra-

California business.[1] The Board concluded that the taxpayer had not sustained its burden of establishing that any part of this deficit was an ordinary and necessary expense of the taxpayer in the operation of the Interstate business; but the decision is silent upon the two questions of law decided adversely to the petitioner by the court below, and presented here for review. The Circuit Court of Appeals affirmed the Board in an opinion (70-78) which did consider and pass, adversely to the petitioner, on the questions of law now before this Court.

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[1] But the findings recite (15) that Interstate organized Stages "for the purpose of augmenting its income from carrying California intrastate traffic." The testimony on this subject is that the reason for doing so was that Interstate, "through the agency of the California Company, might secure a certificate of public convenience and necessity for the California Commission to handle intrastate passengers within the State of California and thereby augment its gross revenue and its net income" (37). The court below recited (72) that it was "for the purpose of augmenting its income by means of additional revenues derived from carrying California intrastate traffic" that Interstate organized Stages.

SPECIFICATION OF ERRORS.

1. The Court below erred in refusing to hold that payment, under contract, of the subsidiary's deficit, was an ordinary and necessary expense of taxpayer.

2. The Court below erred in holding that the deficit was an incident attributable wholly to the business of the subsidiary.

3. The Court below erred in failing to give effect to the agency relationship between taxpayer and its subsidiary.

4. The Court below erred in holding that payment by the taxpayer of the subsidiary's deficit was a capital expenditure and not an ordinary and necessary business expense.

5. The Court below erred in failing to hold that in the conduct of business within the borders of California, Stages was a mere agent or instrumentality of taxpayer.

6. The Court below erred in affirming the decision of the Board of Tax Appeals.

QUESTIONS PRESENTED.

These are:

1. Whether in the case of a payment, pursuant to a contract obligation, and otherwise representing the ordinary and necessary expense of carrying on a taxpayer's business, by the taxpayer corporation to another corporation through which a part of the paying corporation's business is carried on, but which is measured by the receiving corporation's deficit in carrying on such operations, is a capital or an ordinary expenditure.

2. Whether the "agency doctrine," so-called, by which under certain circumstances, separate corporate entities may be disregarded (which still is invoked at the instance of the taxing sovereignty), may no longer be invoked, at the instance of the taxpayer, and, accordingly, whether numerous past decisions applying this doctrine in taxpayers' favor no longer represent the law.

SUMMARY OF ARGUMENT.

I. As to the First Question:

Mere stock ownership does not entitle a stockholder, even a sole stockholder, to deduct a corporation's deficit; but the facts here establish the deduction as an ordinary and necessary expense; for Stages was Interstate's nominal agent as to California operation. Such operation was actually by Interstate, although nominally that of Stages. The pleadings concede that Interstate was engaged in bus transportation between Chicago and California, and the Court below assumed that Stages was Interstate's agent as to that business, even if local law prevented Interstate

from doing intrastate business except through the medium of a domestic subsidiary (which, if ever the case, was not the case in 1936). Although assuming such agency and treating the expense of intrastate business as insignificant, the Court below denied the deduction upon the ground that it was not dependent upon any corresponding unit of benefit to petitioner or sacrifice of the subsidiary, and consequently said to be an incident attributable wholly to the business of the subsidiary. In thus denying the deduction, apparently because contingent on operating results, the Court below erred. Moreover, the recitals in the absorption contract and in the facts in evidence make it plain, that "sacrifice of the subsidiary" was involved in the arrangement, and that it very definitely was for the "benefit" of Interstate. The deduction was plainly "necessary," and was also "ordinary;" for it was directly related to taxpayer's regular business, and was for a business purpose and no element of a tax avoidance was involved.

Payment of expenditures to and through a wholly owned subsidiary instead directly does not preclude their deduction, if otherwise proper, especially if made pursuant to contract, as was the case here. This Court's decision in *Welch* v. *Helvering*, 290 U. S. 111, 54 S. Ct. 8, 78 L. Ed. 212, has no application to the present case and should not be extended to deny the deduction of the economic cost of a normal business operation otherwise clearly deductible. Payment of a subsidiary's deficit, under circumstances such as are here present, is an "ordinary and necessary" expense and not a capital contribution.

II. As to the Second Question:

This question, although often treated as one of "disregard" of separate corporate entities, and sometimes characterized as involving "piercing the corporate veil,"

really is concerned with examination into the true relationships of the entities involved to one another, and other parties in interest. This is not a case of a taxpayer's attempt to repudiate the very entity it has itself set up. The facts establish the relationship of principal and agent, and the fact that such agency exists should be recognized for tax purposes, as in any other case of agency.

The facts of the present case are squarely within *Southern Pacific Company* v. *Lowe*, 247 U. S. 330, 38 S. Ct. 540, 62 L. Ed. 1142. They are stronger in favor of the taxpayer than the facts in *Gulf Oil Corporation* v. *Lewellyn*, 248 U. S. 71, 39 S. Ct. 35, 63 L. Ed. 133. Both of those cases are directly contrary to the government contention that in effect would forbid the assertion of a claim of agency, in cases of this general type. The decision of the Court below cannot be reconciled with either the *Southern Pacific* or the *Gulf Oil Corporation* cases. While it is true that the *Southern Pacific* case has often been said to have turned upon its "peculiar facts," the government contention herein and the decision of the Court below would deny relief even where "peculiar facts" exist. In the present case the facts strikingly parallel those of the *Southern Pacific* case, and the present case is also one of "very peculiar facts."

The cases of *Dalton* v. *Bowers*, 287 U. S. 404, 53 S. Ct. 205, 77 L. Ed. 389, and *Burnet* v. *Commonwealth Improvement Company*, 287 U. S. 415, 53 S. Ct. 198, 77 L. Ed. 399, were both cases in which the parties interested had taken inconsistent positions and sought to have the corporate entities disregarded when disregard operated to their advantage, although having availed themselves of the benefit of the corporate fiction where it operated to their advantage. The element of tax avoidance was present in

both cases, which is not true here. *New Colonial Ice Company* v. *Helvering*, 292 U. S. 435, 54 S. Ct. 788, 78 L. Ed. 1348, involved a successor corporation and no question of agency, and in addition was a case in which there was a change of control; for creditors succeeded, at least temporarily, to the control of the new corporation, instead of the older corporation stockholders (thus suggesting the analogy of the situation in *Helvering* v. *Alabama Asphaltic Limestone Company*, 315 U. S. 179, 62 S. Ct. 540, 86 L. Ed. Adv. Op. 559). Further, the question involved was carrying forward a statutory net loss of the old corporation, not whether deduction of an out-of-pocket payment by the taxpayer itself should be denied. In that case the deduction claimed had not been actually paid by the taxpayer. The claim was that a predecessor's loss might be deducted, under the terms of a statutory provision conferring the right to a special and unusual deduction. The applicability, of the agency doctrine, was recognized in these cases, and the *Southern Pacific* and *Gulf Oil Corporation* cases were referred to with approval.

The case of *Higgins* v. *Smith*, 308 U. S. 473, 60 S. Ct. 355, 84 L. Ed. 406, was one in which a loss was not recognized which was claimed in connection with a transaction between an individual and his wholly owned and completely dominated corporation, which in fact functioned as his agent. Except that the interests of the parties are reversed, the case in some respects resembles the present one. The opinion expressly declares that the purpose of the law is "to tax earnings and profits less expenses and losses," and points out that "if one or the other factors in any calculation is unreal, it distorts the liability of the particular taxpayer to the detriment or advantage of the entire tax paying group." This language makes it plain that actuality, not unreality, should govern,

and that the rule "works both ways." The language relied on by the government, and quoted in the opinion below, in support of the onesided doctrine announced by the Court below was used in connection with this Court's discussion of the *Commonwealth Improvement Company* case, cited by the taxpayer in *Higgins* v. *Smith*, and was directly related to that case and aimed at schemes and sham transactions to escape taxes. *Higgins* v. *Smith* has been cited by the Board of Tax Appeals (*Carling Holding Company* v. *Commissioner*, 41 B. T. A. 493, at page 501) and by the Circuit Court of Appeals for the Tenth Circuit (*Inland Development Company* v. *Commissioner*, 120 Fed. [2d] 986 at pages 988 and 989) in support of contentions of taxpayers asserting the "agency" doctrine. The body of law which is exemplified by the *Southern Pacific* and *Gulf Oil Corporation* cases, and has often, before the decision in *Higgins* v. *Smith*, been applied by both the Board of Tax Appeals and Circuit Courts of Appeals, has not, because of the language in *Higgins* v. *Smith* which is quoted by the Court below, for practical purposes ceased to exist. In the present case the agency relationship should, especially in view of the foregoing authorities, including *Higgins* v. *Smith*, haev been recognized and given effect by the tribunals below.

III. As to the Effect of the Relatively Unimportant California Intrastate Operation:

The volume of the intrastate business was but a little over five per cent of the total revenues allocated to California. As to the remainder, almost 95 per cent, the pleadings admit and the Court assumed the agency relationship. Both tribunals below, though not in harmony as to their reasons, gave controlling effect to five per cent of the business, notwithstanding the fact that operating expenses were not increased by the intrastate business

and would have been the same in any event, a fact which the Court below accepted in recognizing the insignificance of expenses occasioned by the intrastate operation. Both tribunals ignored a California statute passed in 1935 which affirmatively permitted foreign corporations engaging in commerce among the several states to transact in California "such commerce and intrastate commerce of like character." In 1936 Interstate had the right under the California law to carry intrastate passengers. Even if it did not, it made, in Nebraska, a valid contract within its charter powers for the nominal conduct by its subsidiary of the intrastate business. Observance of the technical requirements of a state regulatory statute applicable to only a small part of the business carried did not convert what was actually Interstate's business into that of Stages. But in any event the relatively insignificant volume of the intrastate business, the fact that the latter occasioned no additional expense, and the fact that it was but an appendage of the main interstate business, all unite to make the deduction that of Interstate, the principal. The deficit which was part of the economic cost of the enterprise in which Interstate was engaged, namely, bus transportation, was both "ordinary" and "necessary" and should have been allowed as a deduction.

ARGUMENT.

I.

Payment By a Taxpayer, Under Contract, of the Deficit of Another and Legally Separate Taxable Entity Will Constitute an Ordinary and Necessary Expense If in Fact It Is Such an Expense of Taxpayer's Trade Or Business.

Taxpayer Conducted California Operations Through the Employment of Stages, and Expenses of Such Operation Were Taxpayer's Expense.

No contention is made that mere stock ownership entitles the stockholder of a corporation to deduct a deficit sustained by the corporation. If, however, the facts affirmatively establish it, the payment of such a deficit may actually constitute an ordinary and necessary expense. This might be true irrespective of the circumstances of stock ownership. The operations of parent and subsidiary in the present case were closely integrated, as the California operations were actually but a part of the taxpayer's bus transportation business. Stages was in fact no more than an agent or instrumentality of taxpayer, or its *alter ego*. Indeed, the allegations of the petition and the Commissioner's admissions in his answer definitely establish that this is the case as to the interstate business (*supra*, p. 3). This close integration of the two companies greatly strengthens the case for the deduction; but entirely apart from this question, and even if this close integration of the two corporations had not existed, and irrespective of the intercorporate relationship, the assumption by the taxpayer of the 1936 deficit of Stages was, on the facts, plainly an "ordinary and necessary expense" of this taxpayer.

There was in 1936 no prohibition in the California laws against operation by taxpayer of an intrastate bus business. On the contrary the local statute affirmatively permitted it (See Appendix, *infra*, p. 63). This will readily appear from an examination of the California statutes, although this important fact is not mentioned in either the Board's opinion or that of the Court below. Both opinions, and respondent's brief in opposition to the allowance of the writ, erroneously convey the impression that at all times here material Interstate could not lawfully engage in local business. Whatever may have been the case prior to the 1935 amendment of the California law, such was not true in 1936. The taxpayer admittedly was not under any charter restriction against doing an intrastate business, even if the local law had limited the right to engage in such business to domestic corporations. But even if the taxpayer had lacked the legal capacity itself to engage in intrastate business (which appears to have influenced the decisions of both tribunals below), all of the expense items going to produce the claimed deduction would in any event have been incurred in the interstate business, in which taxpayer had the admitted right to engage, and in which it is admitted it was engaged, in 1936 (13). Stages was taxpayer's agent in the conduct of that business, as the Court below correctly assumed (75).

Yet, and notwithstanding recognition, or at least assumption, by the Court below of the fact of such agency, the Court denied to the taxpayer the deduction of the cost of conducting that business. The opinion reasons that the contract obligation of paying the deficit is not placed "upon the ground of payment for any service rendered or to be rendered by the subsidiary," and places great importance upon the fact that "the amount of the deficit to be paid is not made dependent upon any cor-

responding unit of benefit to the petitioner or sacrifice of the subsidiary"; wherefore, the opinion concludes, "the deficit of 1936 was consequently an incident attributable wholly to the business of the subsidiary." This language is not easy to understand. One might characterize it as a *non sequitur*. One may infer from it that the deduction would have been held proper had it represented, let us say, payment of a fixed amount to the subsidiary, instead of one contingent on operating results.

The contract, and the accounting under it, assigned a certain portion of the interstate and all the intrastate revenue to Stages. Such intrastate revenue was but $10,000 out of $183,365.60 (34). Also allocated to Stages were certain inescapable expenses, items actually paid by Interstate but under the accounting between the two companies allocable to Stages, which totaled $211,470.59. The contract required Interstate to bear the burden of the excess of the latter amount over the total revenues. But for the $10,000 of intrastate revenue, the net expense items, in that case assignable beyond question to taxpayer's interstate business in their entirety, would have been $10,000 more.

The claimed deduction was, therefore, obviously "necessary." If taxpayer had contracted with some private individual to operate taxpayer's buses while in California and account to the taxpayer for earnings, any amounts paid such individual by way of reimbursement for the excess of expenses over revenues, and for compensation, if any, would constitute "ordinary" as well as "necessary" expenses. There are doubtless situations under which payment of a subsidiary's deficit may constitute a capital contribution. The present case, however, is one in which the deficit is directly and intimately related to the taxpayer's regular business operations.

The emphasis on petitioner's supposed incapacity itself to engage in intrastate operations ignores the relative insignificance of the intrastate business (less than one-eighteenth of the total California revenue and adding nothing whatever to the total expense). Further, such incapacity, even if it existed, ought not to preclude such a deduction as a business expense. Thus, if Interstate were to extend its line from Los Angeles to the Mexican border, and beyond, for example to Ensenada, Mexico, but, to comply with Mexican law, were compelled to conduct operations south of the border through a Mexican subsidiary under a similar arrangement, would not a deficit of the latter constitute a business expense, as the term is ordinarily understood, in its common everyday significance? Interstate in such a situation would not be merely investing in the subsidiary, for the purpose of enabling the subsidiary to profit. Considered separately, such ventures are often, perhaps usually, unprofitable; but they may be thought advantageous to the enterprise as a whole. Obviously such a venture would not be undertaken except as part of the principal business activity of the parent. This was true of Stages.

Interstate did not, as the Court below erroneously reasoned, organize Stages so that the latter, separately considered, would be a profitable business venture in the intrastate field.[1] The uncontradicted evidence is to the contrary. The absurdity of such a contention is apparent from the figures of relative revenues. Stages was organized to enable Interstate to benefit from the additional local revenue obtainable if local business could be con-

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[1] This is true, in spite of the fact that the Board's decision was against the taxpayer. The extent to which some of the language in the Board's opinion is contrary to the evidence is discussed below, pp. 57, 59. The statements in the text above are supported by Haugh's uncontradicted testimony (34, 35). Compare also the text of the absorption contract (57) already mentioned (*supra*, pp. 5, 6).

ducted. Having been organized for this purpose, it was also a convenient agency for the nominal conduct of taxpayer's interstate operation in California. The latter operation furnished seventeen eighteenths of all California revenues, and required the expenditure of all of what was paid out for operating expenses. The absorption contract, made in 1932 when there could have been no possible object, so far as taxes were concerned, to misstate the relationship of the parties, recites that Stages was maintained as an operating subsidiary of Interstate, and that its operations were conducted "solely for the benefit of" Interstate, and evidences a purpose that Interstate "may obtain the greatest benefit from the operations of the California corporation," and that in order to get this benefits chedules of the two companies must be coordinated and Stages must "operate on such routes and upon such schedules as will most greatly benefit" Interstate. There is the further recital that "such operation may not be so remunerative to the California corporation as operation solely for its own corporate benefit." This recital alone negatives the assertion of the Court below (*supra*, p. 21) to the effect that "sacrifice of the subsidiary" was not reflected in the deficit. Where an unprofitable subsidiary is thus organized for a business purpose and with no element of tax avoidance involved, as an incident of a main business enterprise and to further that enterprise, it ignores realities to say that a non-capital deficit borne by the parent is not an "ordinary and necessary expense" of the parent.

Payment of Another's Obligation Or Deficit Is a Proper Deduction If Related to Taxpayer's Trade Or Business and Non-Capital in Nature.

Taxpayer's contention on this point has been well stated in a memorandum opinion rendered, in another case, by the Board of Tax Appeals several months after

its decision in the present case, but by a different member. It is now referred to, not as an authority, but because its reasoning, which petitioner herein adopts, expresses succinctly the argument for allowing the deduction. The case is that of *Shasta Water Co.* v. *Commissioner*, Docket No. 102772, not reported officially but available in the Commerce Clearing House Board of Tax Appeals Service as Decision 12411-B. There the taxpayer produced and sold Shasta Springs Mineral water. As an incident to its business, it operated a resort hotel near Mount Shasta, California, on the property on which the springs were located. The hotel was transferred to a wholly owned subsidiary, and because it was anticipated that the subsidiary would lose money the taxpayer agreed with its subsidiary to pay the latter's losses sustained in the operation of the hotel, in exchange for advertising the taxpayer would receive by reason of such operation. The Board held that the payment of the subsidiary's loss pursuant to that contract constituted an "ordinary and necessary" expense. The decisions in the *Shasta* and the present case cannot be reconciled.

The opinion in the *Shasta* case, making no mention of any question of disregard of corporate entity, after pointing out that the record made it clear that in the particular business in which the taxpayer was engaged such a type of advertising was usual and saying that therefore such expenditures were ordinary and necessary business expenses, said further:

> "The fact that these expenditures were made to a wholly owned subsidiary for the purposes of providing for the operation of such a hotel, instead of being made directly by petitioner on account of its own operation of the hotel, can not preclude their deduction. The deduction by a corporation of proper

business expenses paid to subsidiaries for value received does not constitute the filing of consolidated returns or amount to the shifting of profits and losses at will for Federal income tax purposes."

This is substantially the situation in the case at bar. The type of expenses assumed under the "absorption contract," which taxpayer seeks in this proceeding to be permitted to deduct, were of a nature usual and customary, and "ordinary," and certainly "necessary," in the bus transportation business. The California corporation agreed to operate the buses upon such routes and schedules, and under such operating rules and regulations as might be directed by taxpayer, which in turn agreed "to assume and reimburse the California corporation for any deficits incurred by the California corporation in its operations"; and the latter agreed to pay over to taxpayer any profits. There was no voluntary payment of another's expenses; there was a formal assumption, in 1936, in accordance with the formal contract, of certain expenses of a subsidiary, in excess of revenues, in performing a normal and ordinary operation in connection with taxpayer's business. The taxpayer itself actually disbursed the money, and received the revenues. If the intrastate passengers had not been carried, the taxpayer would have had a lower over-all net taxable income; for the expenses of the California portion of the interstate trip would have been no less, but the net deficit allocable to California would have been greater because of the absence of any California intrastate revenues. To assert that this is not an "ordinary and necessary expense" under these circumstances is to close one's eyes to actualities.

In the present case both the Board of Tax Appeals and the Court below relied on this Court's decision in *Welch* v. *Helvering,* 290 U. S. 111, 54 S. Ct. 8, 78 L. Ed.

212, for the general proposition that one taxpayer is not entitled to a deduction for another's expenses voluntarily assumed. There this Court held that the voluntary payment of a debt for which one was not liable, but which was paid for the purpose of strengthening one's business credit, was not, however "necessary," an "ordinary" expense, and was rather in the nature of a capital expenditure. The opinions below would extend the principle of that case to deny the deduction in the present case of the economic cost of a normal business operation otherwise clearly deductible. In the *Welch* case (which is not at all in point here), this Court observed that payment of another's debts "instead of being ordinary is in a high degree extraordinary," and that "there is nothing ordinary in the stimulus evoking it, and none in the response." Conversely, it may be said with equal truth that corporations "ordinarily" do pay expenses, especially of their own subsidiaries, incurred for their benefit. Here the expenses sought to be deducted were current expenses of an existing operation, in a year in which that operation happened to produce a deficit.

There is no decision by this Court of the question whether, upon facts such as are here presented, payment of a subsidiary's deficit constitutes an "ordinary and necessary expense" of the parent. While undoubtedly such a payment by a stockholder is often in fact a capital contribution, the decisions below in effect hold that a parent corporation is estopped ever to establish factually that such a payment is a business expense. Upon this branch of the case petitioner submits that sound reason and logic, and the consideration that actual net income only be subjected to present day high corporate tax rates, compel a reversal of opinions of the tribunals below on this question.

II.

The Close Integration of the Taxpayer and Its Subsidiary Make It Plain Beyond Question That Stages Was But an Agency Or Instrumentality of Taxpayer.

The opinions below exhibit much confusion on the agency question. Thus the Board's opinion stresses Stages' "separate juristic taxable entity" and adds that "the bus business of Stages, limited as it was to the State of California, did not become that of petitioner by virtue of petitioner's sole ownership of the stock of Stages" (18). The Circuit Court of Appeals assumed the agency as to the interstate traffic (75); and yet in the very next paragraph the Court below apparently has rejected its own assumption and refused to apply the doctrine that close integration of parent and subsidiary may, under some circumstances, require treatment of the subsidiary as but an agency or instrumentality. In this connection, and overlooking its own acceptance of the contention that the expense of carrying intrastate traffic is insignificant and that Stages was taxpayer's agent as to the interstate traffic, the Court below says that the subsidiary "was organized primarily to do a business which petitioner had no authority to do." Nor is there in the opinion any mention of the fact that, whatever the pre-1935 law in California, there was no legal obstacle in 1936 to taxpayer's conduct in that State of local transportation.

Cases dealing with the subject of "piercing the corporate veil" contain language to the effect that the separate entity will in a proper case be "disregarded." Perhaps a better approach would be not that of "disregard," but of examining into the true relationships of the entities involved to one another and other parties

in interest.[1] Where the taxing officers seek to "disregard" the entity, the taxpayer relying on it may be prevented for some reason from benefiting by it. That was the case in *Higgins* v. *Smith*, 308 U. S. 473, 60 S. Ct. 355, 84 L. Ed. 406. Or the taxpayer may, in spite of the form employed, not have accomplished his purpose. Compare *Gregory* v. *Helvering*, 293 U. S. 465, 55 S. Ct. 266, 79 L. Ed. 596. Here, in a sense, the taxpayer asks that the fiction be "disregarded." It would, however, be more nearly accurate to say, not that the present taxpayer is seeking to repudiate the very entity it has itself set up, but that the present relationship is, on the facts, that of principal and agent, and that, upon principles familiar in the law of agency, all that is asked is that the actual fact of agency be recognized for tax purposes, just as it would be in any other relationship. There is no rule of law preventing a corporation from being an agent if it is one in fact. Even the opinion below assumed that Stages was Interstate's agent in the conduct of the interstate operations.

Precedents prior to Higgins v. Smith favorable to taxpayer's contention.

There are three important decisions, in tax cases, by this Court dealing with such situations. These are:

Southern Pacific Co. v. *Lowe*, 247 U. S. 330, 38 S. Ct. 540, 62 L. Ed. 1142.

Gulf Oil Corporation v. *Lewellyn*, 248 U. S. 71, 39 S. Ct. 35, 63 L. Ed. 133.

Weiss v. *Stearn*, 265 U. S. 242, 44 S. Ct. 490, 68 L. Ed. 1001.

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[1] Thus the present taxpayer frankly recognized before the Board of Tax Appeals that Stages was a separate "entity" (25).

No contention is made (as the opinion below suggests, 130 Fed. [2d] 136, at p. 140; Rec. p. 76), that these (and decisions of lower courts following them) lay down "any general rule authorizing disregard of corporate entity in respect to taxation." Petitioner recognizes that a corporation is an entity separate from its stockholders. The question here is whether it should be recognized that the subsidiary is but an agency of the parent. The Government's position is that such agency can never be recognized at the taxpayer's instance.

Southern Pacific Co. v. *Lowe* was an action to recover income taxes paid, under protest, upon certain dividends upon stock of the Central Pacific Railroad owned by the Southern Pacific. The dividends were received in 1914, but were alleged to have been paid out of a surplus accumulated prior to the effective date of the income tax act, and of the sixteenth amendment. The Southern Pacific was the sole stockholder of the Central Pacific, and in actual physical possession of the railroads and assets of the Central Pacific, and in charge its operations, which were conducted in accordance with the terms of a lease to the Southern Pacific, one of whose terms was that the Southern Pacific pay lessor $10,000 per year for organization expenses, should operate the road and account annually for net earnings, and, if these exceeded six per cent on lessor's stock, half the excess should be retained by lessee. Advances by lessee for lessor's account were to bear interest. Lessee Southern Pacific was entitled at any time and from time to time to refund to itself its advances and interest out of any net earnings that might be on hand. These provisions were observed for bookkeeping purposes. Southern Pacific acted as cashier and banker for the entire system. Central Pacific had no bank account.

Its earnings were deposited in Southern Pacific's account. If Central Pacific needed funds, they were advanced by Southern Pacific. As a result of these operations and of the conversion of certain capital assets of Central Pacific, that company had a large surplus on its books accumulated prior to January 1, 1913. The dividends in question were declared and paid in 1914 out of this surplus. The payment was however constructive only, and was carried into effect by bookkeeping entries reducing the surplus and reducing the indebtedness of Central Pacific to Southern Pacific. The question was whether such dividends constituted income under the 1913 income tax law. Such dividends, paid out of surplus that accrued prior to 1913, this Court said accrued to Southern Pacific prior to that date "in every substantial sense * * * and hence underwent nothing more than a change of form when the dividends were declared." The following language in the opinion is particularly pertinent to the present inquiry:

> "We base our conclusion in the present case upon the view that it was the purpose and intent of Congress, while taxing 'the entire net income arising or accruing from all sources' during each year commencing with the first day of March, 1913, to refrain from taxing that which, in mere form only, bore the appearance of income accruing after that date, while in truth and in substance it accrued before; and upon the fact that the Central Pacific and the Southern Pacific were in substance identical because of the complete ownership and control which the latter possessed over the former, as stockholder and in other capacities. While the two companies were separate legal entities, yet in fact, and for all practical purposes they were merged, the former being but a part of the latter, *acting merely as its agent and subject in all things to its proper direction and control.* And, besides, the funds repre-

> zented by the dividends were in the actual possession and control of the Southern Pacific as well before as after the declaration of the dividends. The fact that the books were kept in accordance with the provisions of the lease, so that these funds appeared upon the accounts as an indebtedness of the lessee to the lessor, cannot be controlling, in view of the practical identity between lessor and lessee. Aside from the interests of creditors and the public—and there is nothing to suggest that the interests of either were concerned in the disposition of the surplus of the Central Pacific—the Southern Pacific was entitled to dispose of the matter as it saw fit. There is no question of there being a surplus to warrant the dividends at the time they were made, hence any speculation as to what might have happened in case of financial reverses that did not occur is beside the mark. • • • " (Italics ours.)

The opinion concludes with the statement that it turns "its very peculiar facts," which facts, however, were held sufficient to make the subsidiary but an agent. It has sometimes been said that the case is distinguishable on the ground that the subsidiary's earnings had become capital before the sixteenth amendment. But in the very next case in the same volume of the reports, *Lynch* v. *Hornby*, 247 U. S. 339, 38 S. Ct. 543, 62 L. Ed. 1149, this Court held that the circumstance that the dividends had been earned before March 1, 1913, did not avoid the tax.

Southern Pacific Co. v. *Lowe* was explained in a case decided the same day by this Court, *Peabody* v. *Eisner*, 247 U. S. 347, 38 S. Ct. 546, 62 L. Ed. 1152, in the following language:

> "*Southern Pacific Co.* v. *Lowe*, has been reversed this day, *ante*, 330, but only upon the ground that the Central Pacific Railway Company, which paid the dividend, and the Southern Pacific Company,

> which received it, were in substance identical corporations because of the complete ownership and control which the latter possessed over the former as stockholder and in other capacities, so that while the two companies were separate legal entities, yet in fact and for all practical purposes the former was but a part of the latter, acting merely *as its agent* and subject in all things to its direction and control; and for the further reason that the funds represented by the dividend were in the actual possession and control of the Southern Pacific Company as well before as after the declaration of the dividend. * * *" (Italics ours.)

The present case involves a deduction from income, not whether an item is includable in gross income. Otherwise the cases are very similar. Thus in each we have these elements:

1. One hundred per cent stock ownership.

2. Physical possession of the assets (except for Stages' nominal "possession" of the buses while in California).

3. Central direction of the entire enterprise in the parent's interest.

4. Absence of any bank account by the subsidiary, the parent acting as banker.

5. Retention of all revenues and payment of all expenses by the parent.

6. Formal leases, and formal accounting, between parent and subsidiary. In the *Southern Pacific* case the lease ran from subsidiary to parent; in the present case the "operating agreement" is in form bilateral: but Interstate actually conducted the operations, paid the help, and was as much in direct control of the California operation as was Southern Pacific of the operation under lease of Central Pacific's property.

The case of *Gulf Oil Corp.* v. *Lewellyn*, 248 U. S. 71, 39 S. Ct. 35, 63 L. Ed. 133, was a stronger case for the Government than either the *Southern Pacific* or the present case. It is of especial interest because the opinion was written by the late Mr. Justice Holmes, whose insistence on cutting through mere form and recognizing actualities is well known. The opinion is characterized by his familiar brevity, terseness and directness of expression. The taxpayer was a corporation holding stock in other corporations, which, together, like the corporations involved in the present case, constituted a single enterprise, carried on by the taxpayer, which was that of dealing in various phases of the oil business. The subsidiaries retained their earnings, although making some loans among one another, and their funds were invested in properties or required to carry on the business, so that the debtor companies had no money to pay their debts. In January, 1913, the taxpayer decided to take over the previously accumulated earnings and surplus and did so by votes of the companies it controlled. The question was whether the parent was taxable upon dividends, so-called, declared as part of this transaction, and paid, not in cash but by adjustments of the intercompany accounts. Justice Holmes pointed out that the taxpayer "was no richer than before, but its property was now represented by stock in and debts due from its subsidiaries. * * *" He pointed out that "it is true that the petitioner and its subsidiaries were distinct beings in contemplation of law, but the facts that they were related as parts of one enterprise, all owned by the petitioner, that the debts were all enterprise debts due to members, and that the dividends represented earnings that had been made in prior years and that practically had been converted into capital,

unite to convince us that the transaction should be regarded as bookkeeping rather than as dividends declared in the ordinary course by a corporation." He pointed out further that although "the petitioner did not itself do the business of its subsidiaries and have possession of their property as in *Southern Pacific Co.* v. *Lowe,*" yet "the principles of that case must be taken to cover this."

The case for the Government's sweeping contention is outlined in the opinion of the court below in the *Gulf Oil Corporation* case, 245 Fed. 1. With a few modifications of detail, that opinion fits the Commissioner's position in the present proceeding. Yet, Mr. Justice Holmes, speaking for this Court, who concurred in the unanimous opinion in *Southern Pacific* v. *Lowe,* rejected the argument for unreality in favor of the argument for reality. It is difficult to discern a basis of reconciliation between the respondent's position in the present case and that announced by Mr. Justice Holmes in his *Gulf Oil Corporation* opinion.

Examination of the Government's brief in the latter case is enlightening because of the distinctions claimed to exist between its facts and those in the *Southern Pacific* case. The facts of the instant case are closer to the more favorable (to the taxpayer) *Southern Pacific* case than to the *Gulf Oil Corporation* case. Indicative of the striking factual similarity between the "peculiar circumstances" of the *Southern Pacific* case and of the present case is the attempted distinction urged in the Government's brief in the *Gulf Oil Corporation* case between that case and the *Southern Pacific* case. Commencing on page 8 of its brief in that case, the Government quoted the language from *Peabody* v. *Eisner,* 247 U. S. 347, 38 S. Ct. 546, 62 L. Ed. 1152, that has al-

ready been set out above (p. 31), and then asks "what, then, are the 'very peculiar facts' referred to by the Court as taking the *Southern Pacific Company* case out of the general rule?" The brief then enumerates four:

1. The lease whereby the subsidiary is said to have "divested itself of the custody of all its property, so that it had nothing which could be the basis of any dealings with any person except the holding company." Here Stages' two buses were "leased" to Interstate outside of California, and Interstate's buses were "leased" to Stages in California, where they were operated for Interstate's benefit. Stages can hardly be said to have had anything "which could be the basis of any dealing with any person except the holding company."

2. The Management, of which the Government's brief quite properly said, as it could also be said of the management in the present situation: "The court was not dealing with the case where a subsidiary's board of directors, though reflecting the policy of the controlling corporation, actually manages its business. The lease to the holding company left nothing to manage, everything was done by the holding company, not as agent, but in its own behalf." The same situation obtains here.

3. The source of money, as to which the brief points out that the case was not one where the subsidiary collected money in a regular course of business dealings, but on the other hand, that the subsidiary was not a party to any contract with any person except its holding company, nor did the general public have any dealings with the subsidiary, whose only source of income was rent, graduated according to earnings, paid by the holding company. In the present case, the form is slightly different, but the substance is about what it was in the *Southern Pacific* case. Here Interstate's leases of the Los Angeles bus Ter-

minal and the garage were in form transferred to Stages; but Stages, which never had any bank account, necessarily never could carry on any business with the public except nominally.[1] Even the interests transferred to Stages (including the ticket selling agencies and the like) were arranged for with the outside parties by Interstate so that Stages' formal interest came about as a consequence of an inter-company transaction.

4. The character of the dividends, which were only a book transaction, not only in the sense that the holding company kept the funds, but because the subsidiary, since it had cut off all active business, had collected no money, and because it was the holding company that was in business for itself, utilizing the plant of the subsidiary as part of its system, and money was received by the holding company in its own behalf, except that at one time it was credited to, at another, charged against, the subsidiary's account. Substantially the same situation exists here.

The Government then conceded that such a situation called for different treatment from the situation in which the subsidiary deals directly with the outside world (as did the subsidiaries in the *Gulf Oil Corporation* case) in managing property and affairs. Nevertheless, the opinion of Mr. Justice Holmes recognizes the essential reality, which was that these subsidiaries functioned merely as agents, so that what they did was in essence what the principal did, and therefore, that, whatever the form, the agency relationship was the reality. If the Government's brief correctly conceded that the facts in *Southern Pacific Co.* v. *Lowe* were "very peculiar," the same logic requires recognition that the present is also a case of "very peculiar facts."

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[1] See above, p. 8, footnote.

The case of *Weiss* v. *Stern*, 265 U. S. 242, 44 S. Ct. 490, 68 L. Ed. 1001, goes farther on the side of the taxpayer. Both Mr. Justice Holmes and Mr. Justice Brandeis dissented in this case, a circumstance that adds force to the views in which both concurred in *Southern Pacific* v. *Lowe*, and which Mr. Justice Holmes expressed and in which Mr. Justice Brandeis concurred in *Gulf Oil Corporation* v. *Lewellyn*. In *Weiss* v. *Stern* suit was brought to recover taxes alleged to have been overpaid in respect of the sale by the taxpayers of certain transactions in the stock of a business corporation. The question was whether they were taxable on the profit on all or only half of their interests. They delivered certificates representing the entire capital stock of the corporation to a depositary trust company, with which was also deposited by certain bankers, for purchasers, a large sum of cash. Both classes of depositors caused a new corporation to be formed, which took over the assets of the first named company and assumed its debts, and in payment issued to the trust company its authorized capital stock. The old corporation was dissolved. The trust company delivered to the bankers half this new stock, and delivered the other half *pro rata* among the owners of the old stock, the taxpayers involved, together with all the cash; so that the effect of the transaction was that each former holder got half the interest he formerly had, plus cash. The Collector ruled that the transaction was a sale of the entire holding, in each case; the courts below held that the sale was of but the half; and this Court upheld that view. This Court cited the *Southern Pacific Co.* and *Gulf Oil Corporation* cases for the proposition that mere change for purposes of reorganization in the technical ownership of an enterprise, under such circumstances, did not constitute gain.

Petitioner appreciates that some more recent cases (for example, *New Colonial Ice Co.* v. *Helvering*, 292 U. S. 435, 54 S. Ct. 788, 78 L. Ed. 1348, *infra*) may have weakened somewhat the authority of *Weiss* v. *Stern;* but if the case is recognized as a controlling authority, then, *a fortiori*, the present case was wrongfully decided below; while on the other hand the obvious differences between the two cases, and the fact that the dissenting justices participated in the *Southern Pacific* and *Gulf Oil Corporation* decisions, one of whom wrote the opinion in the latter case, emphasizes the importance of these two decisions as precedents governing the present case.

Southern Pacific Co. v. *Lowe* and *Gulf Oil Corporation* v. *Lewellyn* have at times been distinguished, where the facts were different; but they have been many times cited with approval, and the principle applied in each of them has been generally approved and recognized in the later cases. They cannot be reconciled with the Government's contention in the present case, nor with the views of the Court below on this aspect of the case. Nor, it is submitted, can they be factually distinguished from the facts of the instant case. If they are still recognized as correctly stating and applying the law to such facts, the same result must follow in the present case.

Precedents Prior to Higgins v. Smith Cited for the Government Contention.

Of the many cases which have applied the familiar rule that a corporation is an entity separate and apart from its stockholders, three decisions by this Court are often cited in opposition to the application of the "agency" doctrine are: *Dalton* v. *Bowers*, 287 U. S. 404, 53 S. Ct. 205, 77 L. Ed. 389; *Burnet* v. *Commonwealth Improvement Company*, 287 U. S. 415, 53 S. Ct. 198, 77 L. Ed.

399, and *New Colonial Ice Company* v. *Helvering*, 292 U. S. 435, 54 S. Ct. 788, 78 L. Ed. 1348. The two last mentioned were cited in the respondent's brief in opposition to the allowance of the present writ.

In *Dalton* v. *Bowers*, Dalton, the taxpayer, who had a large private income from various sources, busied himself for some twenty-five years with physical research and invention. His inventions brought him no profit. Patents covering his inventions he transferred to a corporation organized by himself, all of whose stock was paid for by him, and of which he was director, president and treasurer. He was in control of its affairs. No other person was financially interested. He testified that his purpose in this venture was to perfect his models and patented articles and sell the corporate shares profitably. He thought it would be better to market his inventions through the corporation, which he considered a branch or a part of his business as an inventor, as a means to an end, an instrumentality of his purpose. He also testified that he believed it essential thus to have his inventions manufactured and brought before the public, and that the corporations were used in order to develop and improve his inventions. The corporation took over certain patents, manufactured the articles, and tried to sell them; and Dalton tried to sell the corporate shares and thereby obtain gain. From time to time he advanced large sums to pay its debts and carry on the corporate business, which loans appeared on the corporate books but were not repaid. Credits were placed to his salary but he withdrew nothing. In 1924 the corporation became insolvent and in 1925 passed out of existence. There had been losses for several years. Dalton paid all the creditors. The corporation and Dalton filed separate income tax returns; and in 1923 and 1924 Dalton claimed

large deductions (over $150,000 in each year) on account of bad debts due from the corporation. In the personal return for 1925 Dalton claimed a deduction of $495,000 which he paid for the worthless shares of the corporation; and the Commissioner ruled that this loss had occurred in 1924. Adjustments for that year produced a large net loss by Dalton, which the Commissioner refused to apply upon the 1925 return because it was not attributable to the operation of a trade or business regularly carried on by the taxpayer. Dalton contended that the loss of 1924 was sustained in a trade or business and that therefore the net loss for 1924 should have been carried forward under the carry-over provisions permitting a carry-over in the case of a loss attributable with a trade or business regularly carried on by the taxpayer. This Court affirmed the Circuit Court of Appeals' decision denying the net loss carry-over.

Dalton's contention, as summarized in this Court's opinion, was that the corporation's entity constituted a part of Dalton's individual trade or business, which was not merely that of inventing but included exploiting of the inventions and selling them through corporations, all of which things were claimed to form a complete, comprehensive enterprise of which the taxpayer corporation was part, as an instrumentality of Dalton's business, so that the investment in the corporate shares was part of a business regularly carried on. This Court disposed of the foregoing contention by pointing out that it rested upon assumptions out of harmony with the facts. Dalton was said not to be regularly engaged in the business of buying and selling corporate stocks. He organized the corporation and took over its shares with the intention of selling them at a profit. The opinion points out that Dalton treated the corporation "as something apart from

his ordinary affairs"; for he accepted credits for salaries, claimed a loss to himself because of loans to it which had become worthless, and caused it to make separate corporation returns. It was said that nothing indicated that Dalton regarded the corporation as his agent with authority to contract or act in his behalf; for ownership of all of the stock was not enough to show that creation and management of the corporation was a part of his ordinary business. The concluding sentence of the opinion is to the effect that "certainly, under the general rule for tax purposes a corporation is an entity distinct from its stockholders, and the circumstances here are not so unusual as to create an exception."

The mere recital of the facts of that case makes it clear how different was the situation presented by that record and the record now here for review. The contention that the corporation was an instrumentality appears to have been based on Dalton's subjective testimony as to what he considered the corporation to be. As the opinion points out, this subjective testimony failed to meet the objective test of Dalton's own actions. The last sentence in the opinion recognizes that there may be an exception where the circumstances are "unusual." The case is nothing more than the application of the familiar rule that mere ownership of stock does not make the corporation's business that of the stockholder.

The *Commonwealth Improvement Company* case, as respondent's brief in opposition to the allowance of the present writ points out (on page 8), was the subject of construction by this Court in *Higgins* v. *Smith*. The taxpayer in *Higgins* v. *Smith* had relied heavily upon the *Commonwealth Improvement Company* case; and the discussion of that case was the direct occasion for the expression of the dictum in *Higgins* v. *Smith* to the

effect that the taxpayer must accept the tax disadvantage of the form of organization he has chosen. The taxpayer in the *Commonwealth Improvement Company* case, a corporation all of whose shares were owned by the Widener Estate (Widener having died in 1915), claimed a deduction on its 1920 income and excess profits tax return for a loss occasioned by the transfer of certain stock to the Estate. The Commissioner refused to allow the deduction and found, instead, that the transaction yielded gain to the corporation. Widener during his lifetime had conveyed to the corporation various stocks, of a large aggregate value, in exchange for its securities. At the time, he was old, and his purpose was to avoid manifold death duties or transfer taxes, and also to insure the safety of an endowment he wished to donate to a favorite charity. Among the securities so transferred by Widener to the corporation were the shares of stock in question. In 1920 a transaction between the trustees of the Estate and the corporation included the transfer to the Estate of the shares in question. The apparent result of the transaction, as the taxpayer returned it, was a net loss, for which the corporation claimed a deduction; but the Commissioner's audit, because of an adjustment made by him to allow for the exercise by the corporation of certain rights to subscribe for new stock, indicated a large gain, in excess of $1,000,000, for which the Commissioner made a deficiency assessment. The taxpayer contended, in the litigation, that under the peculiar facts of the case the transaction resulted in no true loss or gain, it being contended that the corporation was merely the agency or instrumentality of the trustees of the Estate, and that practically the Improvement Company and the Estate were one entity. The opinion of this Court expressly approved the language used by the Board of Tax Appeals which

pointed out that if the taxpayer's contention were logically applied, all income received by it since its organization had been properly taxable as Widener's income and that of the Estate, and should have been added to other income of Widener and the Estate during these years and taxed at the rates applicable to individuals rather than at the corporate rates (one may infer that the income which would have been thus subject to taxation at individual rates would have been in brackets carrying higher rates than the then current corporation rates). The Board was also upheld in saying that for purposes of inheritance and transfer taxes imposed by the various states on the transfer of the stock the corporate entity should have been disregarded at Widener's death, and the stocks subjected to whatever taxes would have been payable had they been owned by Widener. The Board pointed out that the taxpayer "does not seek to carry its contention to such a conclusion," and was upheld by this Court in saying that "having enjoyed the benefits which resulted from its separate existence, it (the corporation) seeks to perpetuate those benefits and asks that the separate existence and tax liability of the petitioner and its single stockholder be overlooked only with respect to transactions which take place between them," which was said to be "an afterthought" which was "plainly evidenced by the action of petitioner in claiming a deduction upon this same transaction when it believed a deductible loss had been sustained."

After thus approving the foregoing expressions by the Board of Tax Appeals, this Court recited that the counsel for the taxpayer had cited *Southern Pacific Co.* v. *Lowe* and *Gulf Oil Corp.* v. *Lewellyn* "not as controlling but as instances where the court looked through mere form and regarded substance"; and then expressly recognized that "unusual cases may require disregard

of corporate form," but said that the record in the case then before it failed to disclose any circumstances sufficient to support the taxpayer's claim. It was specifically pointed out that the corporation was "avowedly utilized to bring about a change in ownership beneficial to the latter (the Estate)"; and that "for years they were recognized and treated as different things and taxed accordingly upon separate returns." The opinion concludes by referring to *Southern Pacific* v. *Lowe* and *Gulf Oil Corp.* v. *Lewellyn* (the latter being said to be "covered in principle by the former") as presenting "peculiar situations." *The Commonwealth Improvement Co.* case falls far short of supporting the Government's contention in cases like the present one. What it held was that a taxpayer corporation organized for the express purpose of minimizing inheritance and transfer taxes, which had for a number of years been regarded by those interested in it as a separate entity for tax purposes as well as other purposes, and which had in respect of the very transaction under review claimed a loss when it thought a loss had been sustained, was estopped to disavow its independent status when that status produced an unfavorable tax result.

The *New Colonial Ice Company* case was one in which all the assets and business of an older corporation were taken over by a new corporation specially organized for the purpose, with substantially the same capital structure, in exchange for a portion of its stock, which was distributed by the older corporation among its shareholders, thereby retiring the old shares. The question was whether the new corporation, notwithstanding the change in corporate entity and ownership, was entitled to have its taxable income for the succeeding period determined by deducting from net income for that period the net losses sustained by the older corporation in the

preceding period. The case resembles that of *Dalton* v. *Bowers* in that, like that case, the net loss carry over section of the revenue laws was involved.

The old corporation had become financially embarrassed and was unable to meet its indebtedness or supply additional equipment needed to render the business profitable. Creditors' and stockholders' committees were organized; and investigation disclosed that there was considerable spurious stock outstanding. Negotiations resulted in the restoration and cancellation of the spurious stock and an agreement to organize a new company to take over the old company's assets and liabilities, which proceeded with the completion of the equipment and continued the operation of the business. An issue of stock by the new company was to be made to the old, equal in class, par value and number of shares, so the old company could exchange the new stock share for share with its stockholders and retire the outstanding stock. Provision was also made for obtaining new funds, for an extension of time by existing creditors, and for giving creditors a supervising management through a voting trust until their claims were paid. The new corporation was accordingly organized, and took over the assets, liability and business of the old. Although the corporate existence of the old corporation continued for a short time thereafter, it transacted no business after the transfer, and had no assets or business. The old corporation had sustained statutory net losses during 1921 and 1922. The new corporation, which took over in April of 1922, realized a net income during 1922 and 1923 and asserted the right under the applicable internal revenue law to a deduction from its income of the losses sustained by the old corporation, insisting that the continuity of the business was not broken by the transfer from the old company to the new.

This court, in denying the taxpayer's contention, pointed out that the continuity had been accomplished by deliberate elimination of the old company and substitution of the new, and then discussed the essential difference between the stockholders and creditors on the one side and the corporations involved on the other. The opinion points out that deductions are allowed only as a matter of legislative grace, and that only as there is a clear provision therefor can any particular deduction be allowed. Reference was also made to the fact that the computation of gains and losses for income tax purposes is "on the basis of a distinct accounting for each taxable year," and that only in exceptional situations, said to have been clearly defined, had there been provision for an allowance suffered in an earlier year. The opinion points out that the statutes had disclosed a general purpose to confine allowable losses to the taxpayer sustaining them, that is, to treat them as personal to him and not transferrable to or usable by another. Accordingly, it was then said, a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms. Referring then to the special provision for the carrying forward of net losses, the opinion refers to this provision as "exceptional." Its words were said to be plain and free from ambiguity, and that, taken according to their natural import, it meant that the taxpayer by whom the loss was sustained the loss was the one to whom the deduction should be allowed. The section was construed as not intended to make a departure of the kind there urged by the taxpayer.

The opinion then proceeded to take up the taxpayer's alternative contention that the deduction should be allowed because for all practical purposes the new corpo-

ration was the same entity as the old one and therefore the same taxpayer. In this connection the opinion points out that this contention was, however, "not in accord with the view on which the stockholders and creditors proceeded when the new company was brought into being," for "they deserted the old company and turned to the new one because they regarded it as a distinct corporate entity and therefore free from difficulties attending the old one." It was then said that "they had sought and reaped the advantages incident to the change." Although the opinion does not mention it, there was a change in the immediate control; for the voting trust provided for the substitution, for a time at least, of creditor control for stockholder control. (Compare *Helvering* v. *Alabama Asphaltic Limestone Co.*, 315 U. S. 179, 62 S. Ct. 540, 86 L. Ed. Adv. Op. 559). The distinct entities of the two corporations were said to have been "plainly implied in the transfer of the assets and business from one to the other," a transfer which was voluntary and contractual and not by operation of law. Then follows this significant sentence:

> "Thereafter neither corporation had any control over the other; the old corporation had no interest in the assets or business, and the chance of gain and the risk of loss were wholly with the new one."

In using this language, which makes it plain that there was no agency relationship between the two corporations, the opinion makes a footnote reference to *Southern Pacific* v. *Lowe* and *Gulf Oil Corp.* v. *Lewellyn*, and also cites in the same connection *Peabody* v. *Eisner*, 247 U. S. 347, 38 S. Ct. 546, 62 L. Ed. 1152, (with special reference to 247 U. S. 347 at page 349, at which appears the language explaining *Southern Pacific* v. *Lowe* which has already been quoted, *supra*, page 31). In denying the contention thus made, in this *New Colonial Ice Company*

case, there is, however, the following express recognition, although stated in terms of "disregard" of the corporate entity, of the agency doctrine:

> "Of course, the rule (that a corporation and its stockholders are separate entities) is subject to the qualification that the separate entity may be disregarded in exceptional situations where it otherwise would present an obstacle to the due protection or enforcement of private rights."

For this statement footnote reference is made to several decisions of this court, in which were again included both *Southern Pacific* v. *Lowe* and *Gulf Oil Corp.* v. *Lewellyn.*

Dalton v. *Bowers, Burnet* v. *Commonwealth Improvement Co.* and *New Colonial Ice Co.* v. *Helvering,* and cases like them, do not, therefore, support the contention that in effect would never recognize the agency doctrine in a case where on the facts a corporation, though a separate entity, is actually but an agency or instrumentality. Further, the factual distinctions between each of these three cases and the case now under review, and language used in the opinion support the petitioner in the present proceeding.

The case of Higgins v. Smith.

In this case it was held that an individual taxpayer could not take a deduction for an alleged loss occasioned by a transaction between himself and his wholly owned and completely dominated corporation, which the opinion terms the taxpayer's "corporate self." Although there is no reference in the opinion to the subject of the corporation's agency for the taxpayer, the facts indicate an agency relationship; but the interests of the parties were the reverse of what they are in the present case.

The individual, the taxpayer, one Smith, organized a corporation whose officers and directors were his own subordinates, and whose transactions were carried on under his directions and were restricted largely to buying securities from and selling to Smith himself. The corporation was created to gain advantages for Smith in the form of income and estate tax savings. The action was brought in one of the District Courts and tried before a jury, which rendered a verdict adverse to Smith's claim that purported sales of securities to the corporation marked the realization of loss on their purchase. The jury had been instructed to determine whether the transfers were "out of" Smith and "into something separate and apart from him," or were simply transfers from his left hand, his individual hand, into his right hand, his corporate hand, "so that in truth and fact there was no transfer at all." A judgment pursuant to this verdict was reversed by the Circuit Court of Appeals; but the decision of that court was in turn reversed by this court.

The opinion says among other things that there was sufficient evidence to support the verdict, and adds that the domination and control was so obvious in a wholly owned corporation as to require a peremptory instruction that no loss in the statutory sense (that the loss is sustained when realized by a completed transaction determining its amount) could occur upon a sale by a taxpayer to such an entity. *Gregory* v. *Helvering*, 293 U. S. 465, 55 S. Ct. 266, 79 L. Ed. 596, was referred to as a precedent for "the disregard of a transfer of assets without a business purpose but solely to reduce tax liability," which was said to give support "to the natural conclusion that transactions, which do not vary control or change the flow of economic benefits, are to be dismissed from consideration." The dicta quoted in the

opinion below of the Eighth Circuit Court of Appeals and quite generally relied upon by the Government in this class of case, which were in connection with this Court's discussion of the *Commonwealth Improvement Company* case and when read together with the context are clearly limited in their application to situations of that kind, follow the following pertinent language:

> "There is no illusion about the payment of a tax exaction. Each tax, according to a legislative plan, raises funds to carry on government. The purpose here is to tax *earnings and profits less expenses and losses.* If one or the other factor in any calculation is unreal, it distorts the liability of the particular taxpayer to the detriment or advantage of the entire tax-paying group."

The foregoing language makes it plain that *Higgins v. Smith* does not sanction the one-sided doctrine relied on by the Government and upheld by the court below. Included in the total revenues collected by the taxpayer in the present case, Interstate Transit Lines, was $183,365.60 of revenue which under the accounting was allocated to California. Included among its disbursements for operating expenses which were actually paid by Interstate was the sum of $211,470.59, which under the same accounting was treated as allocable to Stages. To treat the earnings as those of the agent and the expenses as those of the agent, although both were actually those of the principal, the present taxpayer, in effect defeats the purpose "to tax earnings and profits less expenses and losses"; for the net excess of such allocated expenses over such allocated revenues is eliminated from the calculation of Interstate's net income, and therefore reflects the inclusion of an unreal factor and distorts the present taxpayer's liability, in this case to the "advantage of the entire tax-paying group," and of course to the present taxpayer's disadvantage.

It is after the foregoing language indicating that an unreal factor operating against the taxpayer is no more to be includued in the "calculation" than in a case where recognizing the unreality operates to the Government's disadvantage that the dicta appear which were quoted by the Court below. The sentence immediately following this language recites Smith's citation of *Burnet* v. *Commonwealth Improvement Company* "as a precedent for treating the taxpayer and his solely owned corporation as separate entities." Then it is pointed out that in *that case* the taxpayer, for reasons satisfactory to itself, had voluntarily chosen to employ the corporation in its operation; after which the language appears that a taxpayer is free to adopt such organization for his affairs as he may choose and having elected to do some business as a corporation must accept its tax disadvantages, while on the other hand the Government may not be required to acquiesce, but may look at "actualities," and upon determination that the form is "unreal or a sham" may "sustain or disregard the effect of the fiction as best serves the purposes of the tax statute." The concluding sentences make it plain that this language was directly related to the discussion of the *Commonwealth Improvement Co.* case and was aimed at "schemes of taxpayers to supersede legislation in the determination of the time and manner of taxation"; for it is "command of income and its benefits which marks the real owner of property."

Although the dicta quoted in the opinion below, when lifted from the context, may appear superficially to sup-

port the lower court's conclusion,[1] the entire opinion tends to sustain the present taxpayer. The result in that case was in accordance with actualities. The principal was not allowed to treat a transaction with his creature, his "corporate self," his mere agent, which he controlled and dominated, as if that agent were a separate, independent entity. In at least two decisions by lower tribunals, *Higgins* v. *Smith* has been regarded as supporting the exact opposite conclusion from that urged on by the Government and upheld by the court below. Thus the Board of Tax Appeals, in *Carling Holding Company* v. *Commissioner*, 41 B. T. A. 493, at page 501, in support of its decision in favor of the taxpayer in a case involving the question whether a corporation was but a mere agent, said:

> "Corporate entity in fact, that is, incorporation in due form of law, has often appeared in cases where the entity was ignored for tax purposes, e. g. *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330; *Gulf Oil Corporation* v. *Lewellyn*, 248 U. S. 71; and the very recent decision in *Higgins* v. *Smith*, 308 U. S. 473."

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[1] An interesting article on this subject, entitled "The Function of the Entity in Federal Income Taxation: Recent Developments" by William H. Harrar, a member of the New York Bar employed by the United States Board of Tax Appeals (now the Tax Court), appeared in the January 1941 number of the Minnesota Law Review, 25 Minn. L. Rev. 189. The author points out that "a hasty reading leaves the impression that the Treasury may play fast and loose with legal entities, whenever its adding machines and comptometers tell it that the revenues will thereby wax greater." The article is an interesting discussion of the subject. The writer's analysis is opposed to the one sided doctrine contended for by the government and announced by the Court below.

And the Circuit Court of Appeals for the Tenth Circuit in *Inland Development Company* v. *Commissioner*, 120 Fed. (2d) 986, which was decided in the taxpayer's favor on the ground of the subsidiary's agency, includes *Higgins* v. *Smith* in a collection of cases cited for the proposition that it is "well settled that extraordinary circumstances sometimes exact the disregard of such separateness of entity in the solution of problems relating to taxes." The other cases included which were decisions by this Court were *Southern Pacific Company* v. *Lowe*, *Gulf Oil Corporation* v. *Lewellyn*, *Burnet* v. *Commonwealth Improvement Company*, *Gregory* v. *Helvering*, and *Griffiths* v. *Commissioner*, 308 U. S. 355, 60 S. Ct. 277, 84 L. Ed. 319.

The *Griffiths* case is interesting because it was the alleged conflict between the decisions of the Circuit Courts of Appeals in *Higgins* v. *Smith* and in the *Griffiths* case which were said to have prompted the allowance of certiorari. In the *Griffiths* case Griffiths paid one Lay money for some stock. The investment was unprofitable and the Commissioner allowed a large deductible loss for 1931 from the sale of the stock by Griffiths to a family corporation. Thereafter Griffiths learned that Lay had defrauded him; and as a result of negotiations between the parties, a settlement was arranged under which Lay was to buy the stock back at what Griffiths paid for it; but a corporate device was set up whereby the money, although actually paid to Griffiths' corporation, was to be in turn paid by it to Griffiths in annual installments over forty years. The Commissioner ruled that Griffiths, having been allowed a deduction for loss in 1931 and having recouped his loss through the settlement, was subject to tax in 1933 on the settlement. This court, in an opinion by Mr. Justice Frankfurter, upheld that view, disregarding "the technically elegant arrangement"

which had been devised by a "lawyer's ingenuity." As the opinion says, there was but a simple sale and passage of money, which "was the crux of the business to Griffiths," and which was said to be the "crux of the business" to the Court.

The language in the concluding paragraph in the *Griffiths* case supports the present taxpayer's position. There it is said:

> "We cannot too often reiterate that 'taxation is not so much concerned with the refinements of title as it is with actual command over the property taxes —the actual benefit for which the tax is paid.' *Corliss* v. *Bowers*, 281 U. S. 376, 378. And it makes no difference that such 'command' may be exercised through specific retention of legal title or the creation of a new equitable but controlled interest, or the maintenance of effective benefit through the interposition of a subservient agency."

Corliss v. *Bowers*, 281 U. S. 376, 50 S. Ct. 336, 74 L. Ed. 916, upheld the constitutionality of the provision in the 1924 Revenue Act under which income of a revocable trust was taxable to the grantor. After the sentence quoted by Mr. Justice Frankfurter in the foregoing excerpt from the *Griffiths* case, the opinion in *Corliss* v. *Bowers*, written by Mr. Justice Holmes, points out that a direction to another to pay over income as received to someone else until further orders would of course subject the first individual to taxation upon the amounts so paid. By way of analogy to the present situation, it may be added that if Interstate employed an individual, or an outside corporation, to conduct the California operations, under a similar arrangement as that here involved, no one would doubt that the revenue belonged to Interstate and that the expenses were Interstate's expenses. In the present case the revenues of Stages are, to use

Mr. Justice Holmes' phrase, subject to Interstate's "unfettered command," although in order to receive the revenues Interstate was compelled to bear the burden of the expenses. Mr. Justice Holmes having written the opinion in the *Gulf Oil Corporation* case and concurred in the *Southern Pacific Company* case, it is hardly likely that he would have failed to apply the views expressed by him in *Corliss* v. *Bowers* to a converse situation like that here presented.

In the light of the foregoing analysis, it is evident that the Fourth Circuit Court of Appeals was correct in concluding, in *United States* v. *Brager Building and Land Corporation*, 124 Fed. (2d) 349, that the "body of law" represented by cases such as *Southern Pacific* v. *Lowe* has not "for practical purposes ceased to exist." Yet the court below in very brief language disposes of this legal question by the blanket statement that the corporate entity of the subsidiary cannot be "disregarded" nor the "'tax disadvantage' resulting from its organization avoided," for which *Higgins* v. *Smith* is cited. The *Southern Pacific Company* and *Gulf Oil Corporation* cases are said to have been relied on by the taxpayer, along with the *Brager* and *Inland Development Company* cases, and also *North Jersey Title Ins. Co.* v. *Commissioner*, 84 Fed. (2d) 898. These authorities are disposed of in the single sentence which declares that "they present peculiar situations and were determined upon consideration of them." The opinion fails, however, to point out in what respects these cases are distinguishable; but they are declared to be "not controlling here," for which proposition the *Commonwealth Improvement Company* case and *American Package Corporation* v. *Commissioner*, 125 Fed. (2d) 413, are cited, notwithstanding the fact that the discussion of the problem by the Fourth Circuit Court of Appeals in the opinion in

the latter case supports the present taxpayer's contention. The fact is that the "peculiar circumstances" of the *Southern Pacific* case are to an unusual degree paralleled in the present case. Accordingly that and the other similar cases relied on should have been followed by the Court below. These cases strengthen and indeed compel the conclusion that Stages was but the agent of Interstate, its *alter ego.* In addition, the pleadings admit and the Court below even assumed such agency with respect to the interstate operation, which represented nearly ninety-five per cent of the business. The legal consequences of the agency relationship should, especially in view of these authorities, have been recognized and given effect by the tribunals below, the expenses declared to be Interstate's, and therefore the deficit held to be an "ordinary and necessary expense" of Interstate.

III.

The Limited California Intrastate Operation Did Not Make Payment of Stages' Deficit Any the Less an Ordinary and Necessary Expense of Interstate, Nor Change Stages' Character as Interstate's Agent, Especially as in 1936 a Local Law Provided That a Corporation in California Engaged in Interstate Commerce Might Conduct Intrastate Commerce of Like Character.

Thus far, except for some passing and incidental references, little has been said herein concerning the controlling effect given by both opinions below to the California intrastate operation. The discussion in both opinions makes it necessary to go somewhat into this subject to the end that the questions of law presented by this record be not obscured or confused by this circumstance that a small part of the business conducted in California was intrastate, and that it was to obtain this

augmentation of business that, because of a local regulatory law, Stages was organized. The volume of this intrastate business was but a little over five per cent of the total allocated to California. As to the remaining business, almost ninety-five per cent, the record leaves no doubt that Stages was but an agent, a fact admitted in the pleadings (13) and assumed by the Court below (75). The Board's opinion ignores the agency relationship altogether, but inferentially recognizes its existence as to the intrastate business when it says (18), erroneously, that "whether any or all of the operating deficit of Stages for the taxable year was attributable to the intra-California business of that company is not disclosed," and refers (18, 19), also erroneously, to what it says is "the absence of evidence as to the ordinary and necessary expense of furnishing interstate transportation to and from California." This language seems to imply that the agency rule would apply to the interstate but not to the intrastate operation. This language is not entitled to the weight usually given to a conclusion of the *nisi prius* tribunal on a factual question; for its assertion as to lack of evidence concerning the expense of interstate operation is not only directly opposed to the uncontradicted evidence that no part of the expense was attributable to the intrastate business (34) except for the insignificant cost of extra accounting (42), but is in conflict with the Board's own findings (15, 16) that no additional expense was incurred except such accounting cost.

The Circuit Court of Appeals, although accepting the fact that the additional expense was insignificant and so not falling into this error of the Board, and although recognizing or at least "assuming" Stages' agency, said that the deficit of 1936 was, because of the apportionment

of revenues on a mileage basis, "consequently an incident attributable wholly to the business of the subsidiary," a conclusion impossible to reconcile with Stages' agency as to nearly ninety-five per cent of the entire business.

Both tribunals, therefore, although not in harmony as to their reasons, gave controlling effect to the approximate five per cent of the business, and both bottomed their conclusions on the premise that this part of the business was business which "could not have been the business of petitioner," as the Board expresses it (18), and was business in which Interstate "could not engage," in the language of the Court below (75). In this major premise both tribunals failed to mention a California statute passed in 1935. This Act, a reenactment, with an immaterial amendment, of an Act passed originally in 1915, affirmatively provided that foreign corporations engaging in commerce with foreign nations or commerce among the several states might transact in California "such commerce and intrastate commerce of a like character." (California Public Utilities Act, Deering's 1935 Supplement to California General Laws, Act 6386, page 1622; see Appendix, *infra*, p. 63.) A statute passed in 1927 forbade passenger stage operation without prior approval of the railroad commission (California Public Utilities Act, Section 50¼, Deering's General Laws of California 1931, Act 6386, page 3561, incorrectly given as page 3161 on page 4 of the transcript). It is fairly arguable, in view of the 1915 statute, that the 1927 Act did not by implication repeal the 1915 statute, and therefore that the commission had no power to deny Interstate the right to carry intrastate passengers; but however that may be, the reenactment in 1935 of the 1915 statute made it plain that the 1927 provision respecting the necessity of commission approval as a prerequisite to conducting an

intrastate bus business no longer obtained in 1936 in the case of a corporation like Interstate, and that in that year the California laws affirmatively conferred this right upon such corporations. Although specifically called to the attention of the Court below (79, 80), this point was ignored by that Court.

But even if Interstate could not itself have lawfully carried intrastate bus passengers directly, it still might, and did, validly contract in Nebraska with its subsidiary respecting the entire California operation. There was no charter restriction preventing Interstate from conducting this business, which obviously was within the scope of the activities to conduct which Interstate was organized. It is hard to understand why, even prior to 1935, Interstate, if itself unable, because of local regulations, to conduct the intrastate operation, could not have contracted for the performance of that operation by an entity not so restricted.

As between principal and agent the latter undoubtedly would be the party answerable to the regulatory authorities; but observance of the requirements of the state regulatory statute did not as between these parties convert what was in actuality the principal's business into that of the agent. If there had been a profit, the agent would under the agreement have been compelled to account for it, not by way of dividends but by a direct payment or credit of the amount of such profit. This was in fact done, under the agreement, in prior years in which there were profits (43, 44; Exhibit 3, *ibid*, 61; Exhibit 4, *ibid*, 62), a fact which, singularly enough, is referred to by the Court below (78) as resulting in Stages' having no surplus (which is of course true), and therefore *ipso facto* requiring the conclusion that payment by Interstate of the 1926 operating deficit, which otherwise would

have impaired the subsidiary's capital, was a contribution to that capital. The fact is that Interstate was, as between itself and its subsidiary, lawfully entitled to the excess of revenues over expenses, and also required to bear any excess of expenses over revenues. This was a matter having nothing to do with local regulatory provisions; but it does establish that payment of these expenses constituted an "ordinary and necessary expense" of Interstate.

If, however, the thesis is accepted that when in 1932 Stages acquired the California franchises Interstate was incapacitated itself to conduct the intrastate business and therefore incapable of making a contract as part of its own business operations with a qualified California resident to conduct that business in the latter's name but for Interstate's benefit and as a part of Interstate's business, the fact remains that this branch of the enterprise accounted for only a little over five per cent of the total revenue volume and was responsible for none of the expenses. The intrastate business depended on the prior existence of the interstate operation, not the latter on the former. The interstate operation was already in the field when the intrastate operation commenced; and the absorption agreement emphasizes the dependence of the intrastate business upon the interstate operation. There was no attempt to develop the California intrastate operation as an independent self-sustaining business; but, on the contrary, the California business was to be entirely subservient to the interstate operation, which was taxpayer's main activity. Such intrastate business as might incidentally be secured was a welcome addition to the business as a whole; but there was no effort to engage independently in California intrastate business except as such business might be incidental to the main transportation business. The local business was an appendage to

the interstate business. The collection, nominally for Stages' account, of some $10,000 of intrastate fares, which operated to reduce by that amount what would otherwise have been an Interstate deductible expense, should not, standing alone, preclude the deduction. Indeed that part of the opinion below which declares that the amount to be paid "is not made dependent upon any corresponding unit of benefit to the petitioner or sacrifice of the subsidiary," thus ignoring the express recital in the absorption contract that the operation provided for was solely for the benefit of Interstate and therefore might not be so "remunerative" to Stages as operation "solely for its own corporate benefit" (57), appears not to be influenced by this incidental intrastate traffic, the expense of which is treated as "insignificant" (75). The emphasis in the Board's opinion upon the intrastate operation, and the reference, with somewhat less emphasis, in the opinion of the Court below to the intrastate business as being business in which taxpayer "could not engage" (75), and as being business which taxpayer "had no authority to do" (76), magnify the intrastate operation out of all proportion to its importance.[1] The deficit which was part of the economic cost of the enterprise in which Interstate was engaged, namely, bus transportation, was both "ordinary" and "necessary" and should have been allowed as a deduction.

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[1] If, notwithstanding what is said in the main text, this Court should be of the opinion that there should be some allocation of the expenses to the intrastate portion of the operation, and a more accurate statement of the revenues than the estimate of the Witness Haugh that such revenues were "about $10,000," and if the legal questions now under review, or either of them, are resolved in favor of the petitioner, then it is submitted that there should in the interest of justice be a remand, to enable the petitioner to supply the exact figures.

CONCLUSION.

For the foregoing reasons it is submitted that the Court below erred in deciding that the deficit resulting from the operating expenses allocated to Stages was not an "ordinary and necessary" expense of the petitioner, and that that Court also erred in deciding that the petitioner was precluded from asserting the agency of its subsidiary, Stages, in the conduct of the California operation, and accordingly, that that Court's decision upholding the decision of the Board of Tax Appeals was erroneous and should be reversed, or, if not that, then that that decision should be reversed and the cause remanded for further proceedings.

Respectfully submitted,

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APPENDIX.

Section 23 (a) of the Revenue Act of 1936, 48 St. L. 1658, provides:

> "In computing net income there shall be allowed as deductions:
>
> (a) Expenses.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *"

Section 26 of the California Public Utilities Act (Deering's 1935 Supplement to California General Laws, Act 6386, page 1622), in effect throughout 1936, contains the following proviso:

> "provided, that foreign corporations engaging in commerce with foreign nations or commerce among the several States of this Union may transact within this State such commerce and intrastate commerce of a like character; and, provided, further, that any foreign corporation, which may comply with the laws of this State respecting foreign corporations, and which owns at least ninety per cent of the outstanding capital stock of any other foreign corporation transacting a public utility business in this State, may succeed to the public utility business, franchises and rights of such latter corporation and thereafter continue and carry on such public utility business."

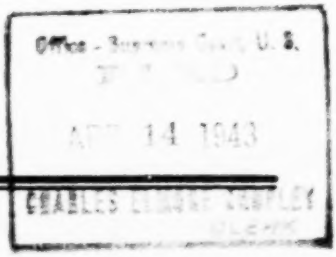
The first four lines of the foregoing (to the semicolon) have been in effect since 1915 (Session Laws, 1915, p. 130). The balance of the above language was added by the 1935 amendment (Session Laws, 1935, p. 1564).

Section 50¼ of the California Public Utilities Act (Deering's General Laws of California, 1931, Act 6386, page 3561, incorrectly given as page 3161 on page 4 of Transcript), adopted in 1927 (Session Laws, 1927, p. 74;

amended in 1931 in a manner not here material, Session Laws, 1931, p. 2598), the statute pleaded, provided in part:

> "No passenger stage corporation shall hereafter operate or cause to be operated any passenger stage over any public highway in this state without first having obtained from the railroad commission a certificate declaring that public convenience and necessity require such operation."

FILE COPY



IN THE

Supreme Court of the United States

OCTOBER TERM, 1942.

No. 552

INTERSTATE TRANSIT LINES,
Petitioner,

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

REPLY BRIEF OF PETITIONER.

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In The

Supreme Court of the United States

October Term, 1942.

No. 552

INTERSTATE TRANSIT LINES,
Petitioner,

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

REPLY BRIEF OF PETITIONER.

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

SUMMARY OF ARGUMENT IN REPLY.

The question of consolidated returns is not involved and the legislative history on this subject is immaterial.

Respondent's argument that the deficit may reflect items not properly deductible from gross income is a new contention made here for the first time, and represents a departure from the theory on which the case was tried

and on which both tribunals below proceeded. The record does, however, contain evidence tending to prove that the deductions were proper as ordinary and necessary expenses. The single item of "bus rental," which respondent suggests should, if Stages is Interstate's agent, be eliminated from the computation, is also reflected in Interstate's gross income, so that if the agency relationship is given effect the items offset each other and Interstate's net income is not artificially reduced by an intercompany account, as respondent suggests.

Respondent concedes the "necessity;" and, the California operation being a part of Interstate's business enterprise, the expense of such California operation was "ordinary" as well. Especially is this true as to the interstate portion of the California carriage. Respondent's assertion that Interstate's business included neither interstate nor intrastate carriage in California conflicts with his own pleading, and is contrary to the assumption made by the court below and contrary to the evidence. His contention ignores realities. The fact is that Stages was but a part, and a small part, of a complete integrated bus transportation system.

The attempted distinction of the *Southern Pacific Company* and *Gulf Oil Corporation* cases on the ground that they were concerned with the question of pre-1913 versus post-1913 earnings ignores this Court's conclusions in each of these cases that what was the subsidiary's income had, because of considerations which are the same as those here urged on petitioner's behalf, already become the parent's income. Respondent's argument ignores the fact that, under *Lynch* v. *Hornby*, 247 U. S. 339, 38 S. Ct. 543, 62 L. Ed. 1149, if, because of such considerations, the income had not already become the parent's, a dividend out of such pre-March 1, 1913 income would if declared after that date have been taxable.

Respondent inconsistently asserts not only Stages' separate entity but the right, in same connection, in effect to disregard that entity, or at least treat it as of little significance, in considering the question of the effect of the contracts. His contention appears to be that because of the sole fact that one of the contracting parties was the other's only stockholder, the tax consequences of the contracts should be different from what they would be if the parties were entirely independent. There is no question of fraud nor is any challenge made to the allocation provided for by the contracts. Consistency in the matter of Stages' separate existence requires recognition of the contractual arrangement, which in effect was one for an agency, and strengthens the evidence establishing the agency.

Respondent's suggestion that the claimed deduction is bottomed on a "mere book entry" is not supported by the record, which on the contrary establishes that it represents a real economic expense. Both tribunals below proceeded on the assumption that the item is real, not a "mere book entry." The evidence establishes that such is the fact.

ARGUMENT.

No Question Involved of Any Attempt to File Consolidated Returns.

(Numerals in Parentheses Refer to Pages of Transcript.)

Much of respondents' brief is devoted to a discussion of propositions not in controversy. Concededly mere stock ownership, which prior to 1934 would alone have entitled any two or more corporations to file consoli-

dated returns, did not in 1936 have that effect. Respondent's extended summary of the legislative history of the 1934 change in regard to consolidated returns amounts to no more than saying that it was the intent of Congress that every corporation (except railroads) file returns of and pay taxes on its own income. This proposition, which is not disputed by petitioner, does not, however, reach the problem in the present case. The statute is plain enough in this respect, and the legislative history adds nothing by way of aid to its construction. Neither a holding that payment of the deficit is an ordinary and necessary expense of the parent nor one that Stages is Interstate's agent (either as to all California business or as to the interstate portion only) can affect Stages' obligation to return *its* net income for taxation, and pay a tax thereon if any tax is due. Payment by Interstate of Stages' deficit automatically must be reflected in Stages' gross income. No question is involved here of any income which may escape tax, nor of duplicate deductions. Interstate does not claim that a consolidated return be permitted in spite of the statute. It is contending that it should pay a tax on *its net income only*, and that respondent is attempting to tax it on $28,100.66 more of net income than it actually obtained. Respondent avoids discussing the unreality of treating Stages as anything but an agent, for a legitimate business purpose, of Interstate. The legislative history of the amendment abolishing the consolidated return privilege has nothing to do with this matter, and is beside the point.

Analysis of Respondent's Argument That the Deficit May Not Have Resulted from Charges Deductible Otherwise from Gross Income.

Although he admitted in his answer (13) that Stages' deficit was $28,100.66, as alleged in the petition (4), respondent now, for the first time, advances the argument that the deficit may have resulted from improper charges.

Heretofore in this litigation there has been no question of this sort suggested, so that it is not surprising that the Board of Tax Appeals, as respondent states (Brief, p. 13), made no findings "respecting the nature or deductibility of the items that produced Stages' net operating loss." If respondent is correct in contending that the items going into the calculation of the deficit should be scrutinized (although this aspect of the matter was never in controversy, so far as the record discloses), then, in the interest of justice, the cause might well be remanded for appropriate findings on the subject, and, if necessary, for further evidence. The record in its present shape does, however, contain evidence tending to establish that the claimed deduction is correct in amount and reflects only proper items of deductions. Respondent's emphasis on this new proposition makes necessary some mention of the evidence on this branch of the case.

After suggesting (Brief, p. 11) the possibility that the deficit may have resulted from non-deductible items,[1] respondent refers specifically to the expense item "bus rental," and then says that "a principal could not directly claim a deduction for rent charged by him against his agent," in which connection he cites *Southern Pacific Co. v. Lowe*, 247 U. S. 330, 38 S. Ct. 540, 62 L. Ed. 1142. Exhibit C (66, 67) shows a complete itemization of expenses, totaling $211,470.59, of which "rent of equipment" appears to be the only item not of the kind that would involve cash payment to outside parties. Respondent is correct in pointing out that a mere inter-company charge

1. Respondent suggests Federal income taxes as an example of such items. Taxes shown in the revenue statement (Exhibit C) are $12,007.61. This is the amount reflected in the deficit. Taxes shown in the ledger account (Exhibit A), when added, come to $14,739.98. The difference which is *not* reflected as a deduction, of $2,732.37 may well have represented Stages' income taxes for prior years paid in 1936, although the record does not disclose what is the fact in this regard, except that a small item of back Federal income taxes shown in the ledger account [illegible] support for this inference.

would not, standing alone, constitute a proper factor in swelling the expense deductions, and therefore the deficit. But the argument proves too much. It also proves that the inclusion in Interstate's gross revenues of the corresponding "bus rental" item should not have been reflected in Interstate's net income.[1] The items eliminate one another.

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1. Gross revenues allocated to Stages were $183,365.60. This is shown on the first page of respondent's Exhibit C (66), which is a statement of revenues and expenses of Stages, Interstate, and another subsidiary (Interstate Transit Lines, Inc.) which is not involved here. This total of revenues includes $12,073.76 of "bus rentals." Respondent refers to page 63 of the record, on which page there is shown his Exhibit A, which is the ledger account showing monthly totals of cash payments by Interstate for Stages, and monthly credits representing revenues allocated to Stages. The "bus rental" credits, when added, total $12,073.76, which is also the figure shown on the revenue and expense statement; the "operating revenues" on this exhibit total $171,291.84; and the combined total of both equals $183,365.60 of revenues, as shown on Exhibit C. The debits of "bus rentals" on the exhibit referred to by respondent total $63,136.92, which represent charges against Stages. On Exhibit C, the corresponding item (shown under transportation expenses, at item 43 as "rent for equipment") is shown, but as $63,226.92. (No explanation appears for the $90 discrepancy.) The same exhibit also shows a large item of "rent for equipment" received by Interstate (at item 13 under operating revenues), amounting to $149,941.37. This of course includes the rental charges against Stages. (The auditor, Hall, testified [48] that the item in favor of Stages designated as "rent for equipment" "represents the use of other companies' equipment—the use of the California Company's equipment on the properties of the other lines," and that "equipment rental which is shown here as being earned by the Nebraska Company [petitioner] is the rent of

If the expenses, which total $211,470.57, are reduced by the "bus rental" item (or "rent for equipment," as it is termed in Exhibit C, which is shown on that exhibit as being $63,226.92),[1] automatically there must be eliminated the same amount from Interstate's gross income. The other expenses shown on the revenue and expense statement all appear to be out of pocket expenses actually paid by Interstate. None of them appears to be of a character that is non-deductible. The elimination of this accounting charge against Stages and of the corresponding credit to Interstate would have the arithmetical result of altering the deficit figure and converting it to a profit, but it also automatically would reduce Interstate's gross income by the same amount, and so would not affect the net result. No question has been made heretofore of the propriety of the accounting allocations as between the two companies. While Stages' expenses should not be inflated by a unilateral charge representing, what would, in respondent's language, "simply be a transfer from the taxpayer's right hand to its left," (Brief, p. 12) this is no such case. Here the charge is reflected by a corresponding increase in

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Nebraska cars operated in California and Illinois territory." The inference is plain that the $63,136.92 (or $63,226.92, whichever is right) is included as a part of the $149,941.37 shown as an operating revenue item of Interstate; and that the $12,073.76 of "rent for equipment" nominally credited to Stages is correspondingly reflected as a charge against Interstate (at item 43). The net result is of course that the $12,073.76 of bus rentals "received" by Stages (and included in the $183,365.60 of revenues) and the $63,136.92 (or $63,226.92) of similar rentals "paid" by Stages and included in the $211,470.59 of expenses shown on Exhibit C were respectively reflected as expenses and receipts of Interstate.

1. The figure is badly blurred in some of the copies attached to the transcript, but it can be demonstrated by reference to the original record and by arithmetic that the figure is $63,226.92.

Interstate's gross income. The parties have tried the cause on the theory[1] that the deficit, of which "bus rental" constituted an item, was properly computed. The respondent's answer specifically admits (13) the allegation of sub-paragraph 7 of paragraph V of the petition (5) that the deficit amounted to $28,100.66. If respondent's argument in this respect at this stage of the litigation has any validity, it at most should call for a remand to the Board for further findings and if necessary further evidence. *Helvering* v. *Wood*, 309 U. S. 344, 60 S. Ct. 551, 84 L. Ed. 796.

Discussion of Respondent's Argument Concerning the Agency Relationship.

Respondent, (Brief, p. 14) stresses the necessity of organizing Stages to obtain the permit for intrastate operation. He ignores completely the fact that in 1936 there was no legal obstacle to direct operation by Interstate of the local business. He makes the assertion (*ibid*) that "had the application been made by Stages as agent for the taxpayer the permit would not have been granted;" but the only requirement of local law as construed by the Commission was that the certificate must run to a domestic company. The operation in California was a part of Interstate's business enterprise. Respondent at the outset of his argument (Brief, p. 8) concedes the "business necessity." This in effect is saying that the expense was

1. In *Helvering* v. *Wood*, the following appears in the opinion: "For a wholly different reason, petitioner's (the Commissioner) argument based on § 22 (a) must fail. The Board of Tax Appeals purported to place its decision solely on § 166 and § 167 of the Act. Petitioner in his assignments of error specifically mentioned only § 166 and § 167 not § 22 (a). In his brief before the Circuit Court of Appeals petitioner expressly waived reliance upon any section other than § 166. Though petitioner in his petition for certiorari relied on § 22 (a), respondent in oppo-

"necessary." Interstate, in the ordinary course of its business, was engaged in bus transportation of which the California interstate operation had been a part ever since the trans-continental operation commenced. The limited intrastate business was of the same general nature and a part of the operation, as a whole, of a complete integrated bus transportation business. Accordingly, the expense was "ordinary" as well and was an expense of petitioner's business. Certainly this is true as to the interstate portion of it, which accounted for all of the expense, a circumstance which is also ignored by respondent, although accepted as a fact by the court below (75).

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sition thereto took the position that that point was not available to petitioner here as it was not raised below. In view of these facts, especially the express waiver below, we do not think that petitioner should be allowed to add here for the first time another string to his bow. As we have indicated, the issues under § 166 and § 22 (a) are not coterminous. Though both deal with concepts of ownership, the range of inquiry under the latter is broad, under the former confined. To open here for the first time and in face of the express disclaimer an inquiry into the broader field is not only to deprive this Court of the assistance of a decision below but to permit a shift to ground which the taxpayer had every reason to think was abandoned in the earlier stages of this litigation."

While in the present case there was no affirmative "disclaimer" of the point now advanced, yet the respondent's brief in the court below recognizes the deductibility, in general, of the expense items and treats the deficit as a true operating deficit. The brief contains no hint of his present argument on this point, nor did either opinion below make the slightest reference to it.

Elsewhere in his argument (Brief, p. 30) respondent makes the assertion that "the business of the taxpayer included neither interstate nor intrastate carriage in California." This assertion is in direct conflict with his own admission (13) that petitioner during 1936 "was engaged in the operation of motor buses for the transportation of passengers between Chicago, Illinois, and Los Angeles, California."[1] It is also in conflict with the assumption made by the court below (75) that Stages was "an agent of the petitioner as a carrier of its interstate traffic in California." In spite of the pleadings, in spite of the close integration of the parties (which alone has in many cases been sufficient to establish the fact of agency), in spite of express recitals in the absorption contract (57) that the operations were conducted "solely for the benefit" of Interstate (language which when construed in the light of the surrounding facts and circumstances merely states in different words the concept of an agency relationship), respondent either ignores these realities, or treats them as of no significance. Where the interests of the parties are reversed, respondent customarily stresses the realities, and the necessity of stern dealing with tax avoidance schemes, as he did in *Higgins* v. *Smith*, 308 U. S. 473, 60 S. Ct. 355, 84 L. Ed. 406, and *Burnet* v. *Commonwealth Improvement Company*,

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1. Paragraph V, subparagraph 4 (5) of the petition alleges that "since 1932 petitioner's California business, both intrastate and interstate, has been conducted by the Stages Company and petitioner has done no business in California." This allegation read together with subparagraph 2 (4) amounts in effect to saying that Interstate's California business was conducted by Stages. Respondent denied this allegation (13) but admitted (13) the allegation of subparagraph (2) that petitioner was engaged in the operation of buses between Chicago and Los Angeles. The pleadings therefore establish the direct contrary of what respondent has asserted (quoted in the text above).

287 U. S. 415, 53 S. Ct. 198, 77 L. Ed. 399.[1] Here, however, he avoids any attempt to support his position on the basis of reality, seeks to extend the doctrine of cases aimed at tax avoidance to this case, in which no such question is present, and, with an emphasis on form instead of substance that he justly rejects when it is the taxpayer who urges it, asserts (Brief, p. 15) that "the taxpayer cannot now disavow the former's (Stages') separate existence or legal responsibility." It is not the taxpayer that is disavowing Stages' separate existence. Stages' separate existence is consistent with its position as a mere agent or instrumentality of Interstate. It is respondent who is insisting on disregard of actualities; for he would disregard the facts evidencing Stages' agency, and even disavow his own formal admissions in the pleadings, and by rejecting the actualities would deny to Interstate a deduction of a part of the actual cost of carrying on its business.[2]

Respondent's Treatment of Southern Pacific Co. v. Lowe, and Gulf Oil Corporation v. Lewellyn.

Respondent attempts to distinguish *Southern Pacific Co. v. Lowe* and the *Gulf Oil Corporation* case (248 U. S. 71, 39 S. Ct. 35, 63 L. Ed. 133) by urging that they were concerned with the question of pre-1913 versus post-1913 earnings. Yet he concedes (Brief, p. 17) that the

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1. Respondent's policy of attempting to extend the principle of such cases, which turn largely upon the question of tax avoidance devices, is in striking contrast to the emphasis he placed on this aspect of *Higgins v. Smith*. Excerpts from his brief in that case which illustrate that emphasis are set out below in the Appendix p. 24).

2. He also, in denying the significance of the absorption contract as one for an agency relationship, refuses himself to accept the full significance of his own contention that Stages' separate entity should be respected. *Infra*, p. 13.

decision in those cases "was that the taxpayer's relation to their wholly owned subsidiaries was such that the income accrued to the former before the 1913 tax date." Pre-1913 income was not taxable; but that circumstance had nothing to do with the question whether or not it was the parent's income, nor whether or not the subsidiary was the parent's agent. The considerations which led to the conclusion that the pre-1913 income had already come into the parent's hands are the same as those here urged on petitioner's behalf. Under respondent's argument the Central Pacific's pre-1913 income continued to be its, not Southern Pacific's, income on March 1, 1913. This, if true, would have subjected a dividend out of that income to tax, as this court held in *Lynch* v. *Hornby*, 247 U. S. 339, 38 S. Ct. 543, 62 L. Ed. 1149, a case ignored by respondent but which demonstrates that it was not the fact that Central Pacific had earned the income before 1913 that was significant; it was the "peculiar circumstances," which before the dividend was declared and before March 1, 1913 made this income for all practical purposes that of Southern Pacific, that led to the result. Courts which have cited these two cases in support of the agency doctrine have not attached any significance to the supposed distinction because the earning of the income antedated 1913. Nor does respondent do so when this suits his purpose.[1]

Respondent in this connection refers (Brief, p. 18) to the identification of wholly owned corporations with their owners as something to be done for tax purposes only

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1. In his brief in this Court in *Higgins* v. *Smith*, he twice cites these same cases for the proposition urged herein by petitioner. See Appendix, *infra*, p. 23. Except for the fact that the present is a converse case, the quoted excerpts are equally pertinent here.

"when required to effectuate an expressed Congressional policy."[1] The policy expressed in section 13 of the statute is that every corporation be taxed on no more than its true net income. If the fact of a subsidiary's agency for its parent exists, that fact should, to effectuate that policy, be recognized just as in the case of any agent.

Reply to Respondent's Discussion of Question Whether Payment of Subsidiary's Loss Is Ordinary and Necessary Expense.

Respondent, under Point II, contends, in effect, that the contractual arrangement between parent and subsidiary should be disregarded because of the close relationship, and therefore that the obligation of the contract be ignored. This contention is in harmony with respondent's general philosophy of "regarding" the entity when it

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1. Respondent distinguishes *Inland Development Company* v. *Commissioner*, 120 Fed. (2d) 986, on the ground of this argument based on "Congressional policy." There the Congressional policy was aimed at preventing tax avoidance by personal holding companies. The taxpayer was literally within the definition of such a company if a certain so-called "dividend" from a subsidiary were included in its income. The interrelation was substantially like the one in the present case. The court there accepted the taxpayer's contention that the so-called "dividend" was not in fact a dividend. In no substantial respect can the case be distinguished from the present one, unless by the circumstance that Interstate had at one time (but not in 1936) been unable to carry on intrastate operations directly. Giving effect to such a distinction would exaggerate the importance of the limited California intrastate business and ignore the insignificance of the expenses allocable to that business; and in any event the payment was none the less a business expense because it was for what the foreign corporation validly contracted to have done in another jurisdiction, but which had to be performed for it by a local resident acting in its interest. (See our original brief, page 22.)

increases taxes but of "disregarding" it when it operates the other way. If that is the law, then a further hazard is added to the conduct of business. Proper and lawful business arrangements involving subsidiaries would under respondent's philosophy expose a business enterprise to the ever present danger of having one corporate entity rule applied in the case of profits, and another in case of loss. Here, however, to sustain the tax, respondent inconsistently invokes both rules in the same connection. He says (Brief, p. 24) that "the contention that an accrual for a business expense can be taken on the basis of a contractual obligation to make up Stages' deficits must rest on recognition that Stages is an entity separate and distinct from the taxpayer for tax purposes," but then immediately says (Brief, p. 25) that it "is certainly not the sort of an arrangement the taxpayer would have made with an independent carrier," and that the stock in Stages "would have been worthless to anyone other than the taxpayer;" and shortly thereafter he asserts that the contract "is one pervaded by the stockholder-corporate relation." A little farther on (Brief, p. 27) he says that "the fact of the stockholder-corporate relation is the dominant characteristic and certainly the only adequate explanation for a contract of the sort here presented." This is stating in different language that the effect should be materially discounted because it is between a stockholder and a controlled corporation.

As a matter of fact the contract emphasizes the agency relationship. It was in essence, at least as to the interstate business, an agency contract.[1] It is by no means

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1. Respondent refers to the Board's observation (18) that the evidence did not disclose what portion of the loss was attributable to this intrastate operation. This, as pointed out in our original brief (page 4, footnote 1) is incorrect.

inconceivable that such a contract might be made between independent corporations. Corporation A might well desire that a certain operation appropriate to its business be carried on by corporation B, and as a price for guaranteeing B against loss might obtain the right to B's profits. One conceivable motive for B's entering into such an arrangement might exist if B were dominated by an individual who would thereby be enabled to obtain a salary, or whose salary would be better secured under such an arrangement. Notwithstanding respondent's suggestion that such a contract might be worthless to A if A were not B's parent, A might have a very definite motive for such a contract. Arrangements of this sort between independent parties are not so anomalous as respondent suggests. All sorts of individual contractual situations exist in the business world. There is no occasion for speculation as to motives which enter into the making of the myriad contractual relationships of economic life. Plainly such an arrangement between independent individuals would be given effect for tax purposes. Such a situation would not be one for contributing to the capital of a corporation, but an expense occasioned in the course of business operations. Yet here, merely because of the close relationship, it is argued that the arrangement should be disregarded. Here again the argument proves too much. The *bona fides* of the contract are not challenged. There is no question of fraud. Disregard of the contractual relations can be justified, if at all, only on the ground that Interstate's domination of Stages is so complete as to make the latter but an agent or instrumentality of the former. Conversely, if the integration of the parties is not sufficiently close to bring the case within *Southern Pacific Co.* v. *Lowe*, and other similar authorities, such for instance as the *Inland Development Company*

case, 120 Fed. (2d) 986, or if the reasoning of those cases is now to be rejected, then respect must be accorded a contract between legal entities as to which there is no claim of any fraud, irregularity, or even mistake, under which one entity performs an operating service for another. The stockholder-corporation relationship does not, standing alone, convert a payment otherwise an expense into a capital contribution.

Just what is meant by respondent in saying (Brief, p. 25) that the nature of payments to Stages is shown "by the fact that they were not measured by its expenses or losses incurred in serving the taxpayer, *i.e.*, by coordinating their schedules," is not clear. The contract recites (57) the purpose to give Interstate the greatest benefit from operation and to arrange for coordinated operation. The formal promise of Stages is to operate buses upon routes and schedules directed by Interstate. The latter agrees to reimburse the former for deficits and the former agrees to pay the latter any profits. Respondent repeats (Brief, p. 26) the assertion that the deficit did not result from this synchronizing service, and asserts further (*ibid*) that "the net loss, rather, was in general one resulting from all Stages' operation in intra and interstate as well." Even if true, this argument is beside the point. As a matter of fact the loss was incurred in the interstate operation (as the court below assumed). What intrastate revenue there was reduced the loss.

An additional significance of the contract is that its provisions meet the criticism of certain authorities which have in similar situations denied relief because the payment has been "voluntary." *National Piano Mfg. Co.* v. *Burnet*, 50 Fed. (2d) 316; *Robinson* v. *Commissioner*, 53 Fed. (2d) 810, 79 A. L. R. 975.

Respondent cites some lower court decisions (Brief, p. 26) for the general proposition that a contribution by a stockholder to replenish a corporation's impaired capital must be treated as a capital expenditure. This general proposition does not reach the facts of a case like this, where the activity producing the year's deficit results from an excess of expenditures over receipts in the conduct of an operation normal to the taxpayer's regular business. If lower court decisions are to be cited in connection with a question that has not previously been decided by this court, the reasoning of and decision in *Wiggin* v. *Commissioner*, 46 Fed. (2d) 743, supports petitioner.

In the same connection respondent says (Brief, p. 29) that "business expenses must be allocated so as to be the expense of the parent or the subsidiary and not the expense of both." This is undoubtedly correct; but the form of statement is misleading and suggests that if petitioner is upheld a duplicate deduction will result in the form of a tax benefit to both entities. Such is not the fact; and respondent may not have intended to convey this impression. Following this observation respondent refers (*ibid*) to the general proposition that losses of the taxpayer are not to be taken by another, even where there is a close relationship, a proposition that may generally be conceded. For this he cites four cases, three[1] of which were discussed in our original brief. Two of these involved tax avoidance schemes, and one a successor entity clearly not an agency, besides also involving a temporary change of control. The fourth, *Burnet* v. *Clark*, 287 U. S. 410, 53 S. Ct. 207, 77 L. Ed. 397, involved a

1. *New Colonial Ice Company* v. *Helvering*, 292 U. S. 435, 54 S. Ct. 788, 78 L. Ed. 1348; *Dalton* v. *Bowers*, 287 U. S. 404, 53 S. Ct. 205, 77 L. Ed. 389; *Burnet* v. *Commonwealth Improvement*, 287 U. S. 415, 53 S. Ct. 198, 77 L. Ed. 399.

majority stockholder of a dredging company. He endorsed its notes and later paid them and was allowed loss deductions. He sought to carry forward the losses, under the carry over provision relating to losses in the operation from a trade or business. He was not in the investment business. The case is like *Dalton* v. *Bowers*, and no more in point here than that case.

The only other decisions of this Court that respondent cites are *Welch* v. *Helvering*, 290 U. S. 111, 54 S. Ct. 490, 78 L. Ed. 212, already discussed in our original brief (on page 25), and *Deputy* v. *DuPont*, 308 U. S. 488, 60 S. Ct. 363, 84 L. Ed. 416, which is clearly not in point, if for no other reason than the circumstances that the taxpayer owned only sixteen per cent of the stock, and that the transaction was of an unusual, not an ordinary, nature. Respondent also cites the English decision reported as *Odham's Press, Ltd.* v. *Cook*, 56 Times Law Reports 704,[1] and *Walker* v. *Gulf & Interstate Ry.*, 269

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1. In the *Odhams Press* case the taxpayer, a printing concern, acquired the stock of "Coming Fashions, Limited," which latter company published the periodical "Everywoman's." The Lord Chancellor's statement of the facts recites that the taxpayer acquired the shares partly to secure work for itself in printing this periodical, and that it was also hoped that the subsidiary, which had been profitable, "would again become a going concern." Accordingly, as he says, the taxpayer was interested in it as a shareholder and hoped to receive dividends, and also "as printers who did work for it at full trade prices." Viscount Maugham's opinion makes it clear that the taxpayer was a creditor of the subsidiary for work done, and that, as he says, the relationship of tradesman and customer existed. He further recites that although the taxpayer wrote off so much of the debt of the subsidiary as represented the subsidiary's loss, yet the debt was not released. No such "peculiar circumstances" of close integration were present as the record in the case under review discloses, nor was there any contract relationship between the companies as exists here.

Fed. 885.[1] Neither case is an authority here; but both are distinguishable by the fact that the advances of the parent were treated as loans and carried as assets, neither involved a contractual relationship like that of the present case, and in neither case were the two corporations closely integrated as here. The *Esmond Mills* case, 132 Fed. (2d) 753, involved a parent's payment to a subsidiary of a sum representing an inventory loss of the latter, and of another sum representing what the latter had to pay to obtain cancellation of an unfavorable contract. In denying the parent the deduction of either item, the court ignored its own prior decision in the *Wiggin* case, 43 Fed. (2d) 743, and relied heavily on the decision now under review herein. Also cited was *American Package Corporation* v. *Commissioner*, 125 Fed. (2d) 413, 140 A. L. R. 642, in which, although the decision on the facts was adverse to the taxpayer in result, the reasoning supports the petitioner.

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1. In the *Walker* case a railroad company, the taxpayer, organized a terminal company, which had separate books and accounts and was managed by a separate set of officers. Its operations were financed by the railroad company, which advanced the terminal company moneys to enable it to meet operating expenses. The Terminal Company never repaid any of such advances. There is no mention in the report of the case of any contract obligation. The sums in question were charged on the railway books "as advances to the Terminal Company and as a debt due by it," and were "so carried on the books of the Terminal Company." (Compare the contrary treatment in the present case on the books of both Interstate and Stages, and the definite contract provision negativing any debtor and creditor relationship with respect to

Reply to Respondent's Suggestion That the Deduction Claimed Was Mere Book Entry.

Respondent at two places toward the end of his argument injects the notion that what is involved is only bookkeeping. Thus he says (Brief, p. 29) that the contract requirement is one "to shoulder the subsidiary's loss via a mere book entry;" and the last sentence of his argument (Brief, p. 32) says that "no arrangements for book entries • • • can defeat the Commissioner's right • • •" It is not clear whether he intends to convey the impression that, somehow, the deduction does not represent a real sustained expense of Interstate. The latter actually paid out the cash payments, which appear to have constituted the entire operating expenses except bus rental. The latter was a proper operating expense item which is offset in the computation of Interstate's net income by the inclusion of the amount of it in gross receipts (*supra*, pp. 5-7). Respondent concedes, and even asserts, (Brief, p. 30) that "the soundness of the allocation method followed is not in issue." Indeed, although he disparages the claimed deduction as a "mere book entry," his whole contention is predicated on bookkeeping allocations between the two companies. The amount of the deficit is conceded. The tribunals below have proceeded on the assumption that the item is a real one, not a "mere book entry." The review here of the legal questions should not be concerned with a fact question, which though lurking in the record, played no part in either tribunal's decision. The accounting entries represent the manner in which the

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deficits and, instead, providing for assumption by taxpayer of this expense burden.) The opinion recites that there was "a loan from the company to another" which was "carried on the books of each company as an advance by one still owed by the other," and the conclusion was reached that the corporate entities could not be disregarded and that what appeared as an advance, and therefore a debt, on the taxpayer-parent's books could not be deducted.

net expense, $28,100.68, (or difference in Interstate's net income if the bus rental is eliminated on both sides of the account) was reflected on the books.[1] The accounting was proper and is not challenged. If the entry represents "mere bookkeeping," and is therefore not to be given the effect claimed for it, then under the *Southern Pacific Company* case the entire system of allocation of charges must likewise be disregarded as mere bookkeeping. The result, so far as Interstate's net income is concerned, is the same. In either case it is $28,180.66 less than respondent contends.

---

1. Exhibit A shows the ledger account of cash advances and charges for bus rental, and of allocated revenue receipts and bus rental credits. At the beginning of the year Stages had a credit balance of $67,543.12 (63). This reflects previous years' profits. The 1936 operations resulted in payments and charges of more than was received and credited. At the end of the year the credit balance was $41,637.22. Accumulated profits of Stages, and under the contract belonging to Interstate, which at the beginning of the year were $75,612.84 (Exhibit 3, Rec. 61), had at the end of the year been reduced by the year's operating loss of $28,100.66 to $47,512.18. This amount represents Stages' indebtedness to Interstate, under the contract, for accumulated profits and was carried as such, but did not reflect the balance, on the ledger account. The difference between the ledger credit balance, at the end of the year (63), $41,637.22, and the Stages' obligation at the beginning of the year for past profits, $75,612.84, which is $33,975.62, represented Stages' obligation before subtraction of the deficit. As between the parties, payment of the deficit was accomplished by entries having the effect of crediting $28,100.66 against this indebtedness. The result was to reduce it to the difference of the two last named sums, or $5,874.96. The details are described in Hall's testimony on cross-examination (44 to 55, inclusive) and fully shown on the balance sheet (Exhibit B, 65) and the ledger accounts (Exhibit A, 63). The $28,100.66 is the net difference in Interstate's 1936 actual income over expenses, or in actual net income, that was occasioned by the California operation.

CONCLUSION.

Because of the California operation, most of it interstate business, petitioner's actual net income for 1936 was $28,100.66 less than respondent and the tribunals below have determined. Stages was Interstate's agent in the conduct of that business. Recognition of this fact does not involve disavowal of the separate existence of Stages. Recognition of the entities also involves recognition of their contractual relationship, which was one whereby Stages became Interstate's agent. There is no fraud, attempted evasion of taxes or estoppel against showing the true relationships. Realities support the petitioner. Respondent's contention ignores realities.

Respectfully submitted,

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APPENDIX.

Excerpts from respondent's brief in *Higgins* v. *Smith* on file in this Court.

A. Excerpts dealing with the agency doctrine:

On pages 17 and 18 of respondent's brief in *Higgins* v. *Smith* the following appears:

> "The decision of the court below exalts form above substance in a way contrary to the purpose of the tax laws. Cf. *Gregory* v. *Helvering*, 293 U. S. 465, 470; *Minnesota Tea Co.* v. *Helvering*, 302 U. S. 609, 613-614; *United States* v. *Phellis*, 257 U. S. 156, 168; *Lucas* v. *Earl*, 281 U. S. 111, 114; *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330; *Gulf Oil Corp.* v. *Lewellyn*, 248 U. S. 71."

On pages 28 and 29 of that brief the following appears:

> "Our position does not necessarily involve a disregard of the corporate fiction. It may be conceded, as in the *Gregory* case (p. 469), that when Innisfail was organized, a 'valid corporation was created.' And it may further be assumed *arguendo* that technical title actually passed to the corporation in the various sales which respondent undertook to execute to it. The gist of our position is that such 'sales' did not and could not constitute such final dispositions of the securities so as to bring about a 'loss' within the meaning of the statutory provisions. Our contention is therefore not in conflict with the results reached in such cases as *Dalton* v. *Bowers*, 287 U. S. 404; *Burnet* v. *Clark*, 287 U. S. 410; *Burnet* v. *Commonwealth Imp. Co.*, 287 U. S. 415; and *Klein* v. *Board of Supervisors*, 282 U. S. 19. In those cases, corporations were employed to conduct certain affairs, and this Court held that the taxpayers were bound by the tax conse-

quences which flowed from the use of corporations. The Court there simply refused to disregard the corporate entity where those interested in the enterprise had selected the corporate form and were seeking to avoid the consequences of that choice. The instant case does not require a disregard of the corporate fiction; we merely urge that no deduction is given by Section 23(e) under these circumstances."

"But even if it were necessary to disregard the corporate fiction there is persuasive authority that would justify such a course. In *McCaskill Co.* v. *United States*, 216 U. S. 504, 515, this Court noted a 'growing tendency' to look beyond the corporate form. See also *United States* v. *Lehigh Valley R. R. Co.*, 220 U. S. 257, 272-274; *Chicago, M. & St. P. Ry. Co.* v. *Minn. Civic Assn.*, 247 U. S. 490, 500-501. And in two cases arising under the first of our modern income tax statutes, this Court pierced the corporate veil. *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330; *Gulf Oil Corp.* v. *Lewellyn*, 248 U. S. 71. In *New Colonial Co.* v. *Helvering*, 292 U. S. 435, where the taxpayer sought unsuccessfully to disregard the corporate entity, the Court nevertheless plainly stated that (p. 442):

"'• • • the separate identity may be disregarded in exceptional situations where it otherwise would present an obstacle to the due protection or enforcement of public or private rights. • • •'

"We respectfully submit that the instant case presents just such a situation as was referred to in the *New Colonial Co.* decision, and that *Dalton* v. *Bowers*, 287 U. S. 404, and like cases are to be assimilated to the *New Colonial Co.* case itself."

B. Excerpts dealing with the importance in the case of tax avoidance:

On page 5 of that brief the following appears:

"2. *Purposes and operations of Innisfail.*—The Innisfail Corporation was formed by taxpayer for the purpose of avoiding inheritance and income taxes (R.

35). At the time he formed the Innisfail Corporation, he had in mind the taxable gain which would accrue from the exchange of Chrysler preferred for Chrysler common (R. 35). And he knew that a corporation would not pay a tax on its income which an individual would have had to pay as a result of the dividend payments on the Chrysler stock contributed by him to Innisfail Corporation (R. 49)."

On page 17 the following appears:

"And where the taxpayer has boldly undertaken to create artificial losses by paper transactions, it is particularly important to keep in mind the recent words of this Court that 'It is in the public interest that no one should be permitted to avoid his just share of the tax burden except by positive command of law.'"

On page 19 the following appears:

"The Revenue Act contemplates genuine losses, recognized as such by the business world, not fictitious losses resulting from transfers by the taxpayer to his incorporated pocketbook. Deductible losses might as well be allowed when the taxpayer on his books transfers an investment from one account to another."

On pages 20 and 21 the following appears:

"Innisfail was created and persistently used, with negligible exceptions, for the specific purpose of serving respondent in his efforts to avoid taxes. In the year in question he realized large amounts of income that would ordinarily have been subject to tax unless offset by the phantom sales. While those sales may have been real in the narrow sense that title passed, they were wholly unreal in the sense that respondent never parted nor ever intended to part with his unfettered control over the securities in question.

"Innisfail was obviously not organized for the purpose of trading in the outside business world. The record shows that it was created and used for an

entirely different purpose. The trading was practically all with the taxpayer, who ignored the corporate entity in substantially every transaction he had with it. From the creation of Innisfail until the year in question the taxpayer took all the dividends and cash that came in, ignored the corporation's bank account, and appropriated the funds to his own uses; but at the same time he was able to place the dividends on the books as belonging to the corporation and avoid the surtax that he would have had to pay if he had returned them as his own (R. 44-51)."

On page 22 the following appears:

"A contrary holding would mean that Congress in providing for the deduction of losses *sustained* during the taxable year was nevertheless willing to sanction so obvious a device for circumventing the condition it so carefully spelled out."

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DEC 13 1942

No. 552

In the Supreme Court of the United States

OCTOBER TERM, 1942

INTERSTATE TRANSIT LINES, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OCTOBER TERM, 1942

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INTERSTATE TRANSIT LINES, PETITIONER

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 16–21) is reported at 44 B. T. A. 957. The opinion of the Circuit Court of Appeals (R. 86–95) is reported at 130 F. (2d) 136.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered July 31, 1942 (R. 95–96). Petition for rehearing was denied September 8, 1942 (R. 103). Petition for a writ of certiorari was filed November 28, 1942. The jurisdiction of this

Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether a deficit incurred by a wholly owned subsidiary of the taxpayer and paid by taxpayer pursuant to contract was deductible from gross income as an ordinary and necessary expense in carrying on the business of the taxpayer, under Section 23 (a) of the Revenue Act of 1936.

STATUTE INVOLVED

Revenue Act of 1936, c. 690, 49 Stat. 1648:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *.

STATEMENT

The taxpayer is a Nebraska corporation engaged in the operation of interstate bus transportation lines between Chicago, Illinois, and Los Angeles, California, handling intrastate business in Iowa, Nebraska, Kansas, Colorado, Wyoming, Utah and Nevada (R. 16–17). It was unable to handle intrastate business in California because the Railroad Commission of that State had refused to grant to foreign corporations authority for intrastate operation (R. 17). In 1930, the taxpayer, in

order to increase its income by carrying California intrastate traffic, which it could do without substantial increase in its facilities or expenses, organized a subsidiary corporation, Union Pacific Stages of California, under the laws of California. The subsidiary was authorized to conduct intrastate operations in California. (R. 17.)

The taxpayer furnished all the capital of the subsidiary and held all its capital stock. The two corporations entered into contracts which provided that the subsidiary would operate on such routes and schedules as would most benefit the taxpayer, as directed by the taxpayer, that the taxpayer would assume and reimburse the subsidiary for any operating deficits incurred by it, and that the subsidiary would pay to the taxpayer any profit resulting from its operations. It was further agreed that the subsidiary, in addition to operating its intrastate business, would also conduct the interstate operations of the taxpayer in California. (R. 17.)

The taxpayer and the subsidiary had the same officers and directors. The subsidiary had its own accounting records and corporate books which were kept in the offices of the taxpayer. The subsidiary had no bank account and taxpayer collected its revenues and paid its bills. The revenues and expenses of both corporations were apportioned between them on the basis of passenger and traffic miles. (R. 18.)

For the calendar year 1936, the subsidiary incurred an operating deficit of $28,100.66 which was charged to the taxpayer as of December 31, 1936. A corresponding credit was entered upon the subsidiary's books on the same date. On December 31, 1936, before these entries were made, the subsidiary was indebted to the taxpayer in a net amount of about $34,000, so that the entries made with respect to the alleged deficit of $28,100.66 merely reduced the net indebtedness of the subsidiary to the taxpayer by the amount of the deficit and left the subsidiary still indebted to the taxpayer in an amount exceeding $5,000. For the years 1932 and 1933, affiliated returns were filed by the taxpayer and the subsidiary. (R. 19.)

Several years after 1936, the taxpayer was able to obtain authority to conduct intrastate business in California and the subsidiary was therefore dissolved and its assets transferred to the taxpayer (R. 19).

The taxpayer sought to deduct the 1936 deficit of $28,100.66 of its subsidiary as an ordinary and necessary expense of its own business. The Commissioner disallowed the deduction and assessed the deficiency under review. (R. 19.) The Board sustained the Commissioner's determination (R. 19–21), and the court below affirmed (R. 95).

ARGUMENT

The court below held that the deficit of the taxpayer's subsidiary was not deductible by the tax-

payer as an ordinary and necessary business expense and rejected the taxpayer's contention that the separate entity of the subsidiary corportation should be here disregarded. The decision was correct; it turns upon its own facts; and it presents no conflict.

1. The deduction here involved was not an expense of the taxpayer's business. The taxpayer was engaged in the business of *interstate* transportation. It lacked legal capacity, under the laws as then construed, to engage in *intrastate* transportation within the State of California. To permit its facilities to be used in intrastate transportation in California the taxpayer formed the subsidiary corporation which secured the necessary authority to engage in the intrastate transportation in California from which the taxpayer was barred.

Taxpayer's payment of the deficit incurred by its subsidiary was not, therefore, a business expense of the taxpayer. Deductions for losses are normally available only to the taxpayer sustaining them, and identity of economic interests does not vary the rule. *New Colonial Co.* v. *Helvering*, 292 U. S. 435, 440. Nor is it important that the taxpayer was bound by contract to pay the item in question. *Deputy* v. *du Pont*, 308 U. S. 488, 498.

The taxpayer urges (Pet. 11) that the decision of the court below conflicts with *Wiggin* v. *Commissioner*, 46 F. (2d) 743 (C. C. A. 1). But that case presented facts markedly different from

those involved here. In the *Wiggin* case, the principal stockholder of a depressed company entered into a contract with it to take over the business and run it for a specified number of years, agreeing to pay all costs on the understanding that he was to retain any profits. The court construed the contract to attribute the losses to the contracting individual and accordingly allowed him the corresponding deduction. It further observed (p. 745) that if there were doubt whether the business taken over by the taxpayer was the taxpayer's business, the losses were in any event deductible under section 214 (a) (5), as "incurred in any transaction entered into for profit."

Here, as we have noted, the business of the subsidiary was not only not the taxpayer's business but it was business which the taxpayer could not transact.

Other cases urged by petitioner as in conflict similarly involved different situations. In *New York, C. & S. L. R. R. Co.* v. *Helvering*, 71 F. (2d) 956 (App. D. C.), the payments of taxpayer were made by it as a part of its own business as operating lessee. *Western Maryland Ry. Co.* v. *Commissioner*, 33 F. (2d) 695 (C. C. A. 4),[1] and *New York Cent. R. Co.* v. *Commissioner*, 79 F. (2d) 247 (C. C. A. 2), certiorari denied, 296 U. S.

[1] Cf. *May Oil Burner Corp.* v. *Commissioner*, 71 F. (2d) 644 (C. C. A. 4), in which the same court recognized the rule applied by the court below in this case.

653, involved the right of a successor corporation to deduct the annual amortization of discount of bonds issued by the predecessor corporation. Relief was there granted upon a theory inapplicable to the instant case, and indeed, in the *New York Cent. R. Co.* case, the court expressly distinguished such a case from those disallowing the deduction by one corporation of another corporation's loss.

2. The taxpayer further contends (Pet. 14–19) that the refusal of the court below to disregard the separate entity of the subsidiary corporation is in conflict with a number of other decisions. But plainly it cannot be said that there is a conflict simply because in some cases the corporate entity is disregarded, while in others it is not. The question when corporate entities may be disregarded must necessarily hinge upon the peculiar facts and issues involved in each case.[2]

Thus *Inland Development Co.* v. *Commissioner*, 120 F. (2d) 986 (C. C. A. 10), involved the application of the personal holding company statute and turned upon its own unique facts. Moreover, the case involved an assessment of income rather than a deduction and the court concluded that the taxpayer did not fall within the scope of the statute. In *North Jersey Title Ins. Co.* v. *Commissioner*, 84 F. (2d) 898 (C. C. A. 3) where the

[2] Compare *United States* v. *Brager Building & Land Corp.*, 124 F. (2d) 349 (C. C. A. 4), with *American Package Corp.* v. *Commissioner*, 125 F. (2d) 413 (C. C. A. 4).

taxpayer was permitted to disregard the corporate entity of the subsidiary, the subsidiary was organized merely to hold title to property of a fraudulent debtor in protecting the existing business of the taxpayer. *United States* v. *Brager Building & Land Corp.*, 124 F. (2d) 349 (C. C. A. 4) involved a like situation. See *American Package Corp.* v. *Commissioner*, 125 F. (2d) 413 (C. C. A. 4).[3]

The taxpayer relies generally (Pet. 16) upon *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, and *Gulf Oil Corp.* v. *Lewellyn*, 248 U. S. 71. But as this Court stated in *Burnet* v. *Commonwealth Imp. Co.*, 287 U. S. 415, 420, those cases presented peculiar situations and cannot be regarded as establishing a general rule authorizing disregard ot corporate entity in respect of taxation. In *Higgins* v. *Smith*, 308 U. S. 473, 477, construing its own decision in the *Commonwealth Imp. Co.* case, *supra*, this Court said that, while a taxpayer is free to adopt such organization for his affairs as he may choose, if he elects to do some business as a corporation "he must accept the tax disadvantage." Cf. *Watson* v. *Commissioner*, 124 F. (2d) 437 (C. C. A. 2), *Texas-Empire Pipe Line Co.* v. *Commissioner*, 127 F. (2d) 220 (C. C. A. 10), and

[3] *Munson S. S. Line* v. *Commissioner*, 77 F. (2d) 849 (C. C. A. 2d), is a unique case where the corporate entity was disregarded to give effect to the intent of Congress as expressed in special legislation enacted to encourage merchant marine operators.

Commissioner v. *Moline Properties, Inc.* (C. C. A. 5th), decided November 7, 1942, not yet officially reported but may be found in 1942 C. C. H., Vol. 4, paragraph 9728; cf. *Gray* v. *Powell,* 314 U. S. 402, 414.

CONCLUSION

The court below correctly applied principles enunciated by this Court. There is no conflict of decisions. The petition for writ of certiorari should be denied.

Respectfully submitted.

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DECEMBER 1942.

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FILE COPY

No. 552

In the Supreme Court of the United States

OCTOBER TERM, 1942

INTERSTATE TRANSIT LINES, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT

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In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 552

INTERSTATE TRANSIT LINES, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 14–19) is reported at 44 B. T. A. 957. The opinion of the Circuit Court of Appeals (R. 70–78) is reported at 120 F. 2d 136.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered July 31, 1942 (R. 78–79). Petition for rehearing was denied September 8, 1942 (R. 82). Petition for a writ of certiorari was filed November 28, 1942, and was granted on March 8, 1943 (R. 87). The jurisdiction of this Court

rests on Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether a deficit incurred by a wholly owned subsidiary of the taxpayer and paid by taxpayer pursuant to contract was deductible from gross income as an ordinary and necessary expense in carrying on the business of the taxpayer, under Section 23 (a) of the Revenue Act of 1936.

STATUTE INVOLVED

Revenue Act of 1936, c. 690, 49 Stat. 1648:

> SEC. 13. NORMAL TAX ON CORPORATIONS.
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> * * * * *
>
> (b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the normal-tax net income of every corporation, a normal tax as follows:
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> * * * * *
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> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
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> In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *
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> * * * * *
>
> SEC. 52. CORPORATION RETURNS.
>
> Every corporation subject to taxation under this title shall make a return, stating specifically the items of its gross income and the deductions and credits al-

lowed by this title and such other information for the purpose of carrying out the provisions of this title as the Commissioner with the approval of the Secretary may by regulations prescribe. * * *

STATEMENT

The facts as found by the Board of Tax Appeals (R. 14–17) may be summarized as follows:

The taxpayer is a Nebraska corporation engaged since 1929 in the operation of interstate bus transportation lines between Chicago, Illinois, and Los Angeles, California, handling intrastate business in Iowa, Nebraska, Kansas, Colorado, Wyoming, Utah, and Nevada (R. 14). It was unable at the outset to handle intrastate business in California because the Railroad Commission of that State had refused to grant to foreign corporations authority for intrastate operation (R. 14–15). In 1930, the taxpayer, in order to increase its income by carrying California intrastate traffic, which it could do without substantial increase in its facilities or expenses, organized a subsidiary corporation, Union Pacific Stages of California, under the laws of California. The subsidiary was authorized to conduct intrastate operations in California. (R. 15.)

The taxpayer furnished all the capital of the subsidiary and held all its capital stock. The two corporations entered into contracts which provided that the subsidiary would operate on

such routes and schedules as would most benefit the taxpayer, as directed by the taxpayer, that the taxpayer would assume and reimburse the subsidiary for any operating deficits incurred by it, and that the subsidiary would pay to the taxpayer any profit resulting from its operations. It was further agreed that the subsidiary, in addition to operating its intrastate business, would also conduct tl. interstate operations of the taxpayer in California. (R. 15.)

The taxpayer and the subsidiary had the same officers and directors. The subsidiary had its own accounting records and corporate books which were kept in the offices of the taxpayer. The subsidiary had no bank account and taxpayer collected its revenues and paid its bills. The revenues and expenses of both corporations were apportioned between them on the basis of passenger and traffic miles. (R. 16.) The subsidiary owned two buses (R. 16), which it pooled with those of the taxpayer under a reciprocal lease arrangement (R. 15, 16).

For the calendar year 1936, the subsidiary incurred an operating deficit of $28,100.66 which was charged to the taxpayer as of December 31, 1936. A corresponding credit was entered upon the subsidiary's books on the same date. On December 31, 1936, before these entries were made, the subsidiary was indebted to the taxpayer in a net amount of about $34,000, so that the entries made with respect to the alleged deficit

of $28,100.66 merely reduced the net indebtedness of the subsidiary to the taxpayer by the amount of the deficit and left the subsidiary still indebted to the taxpayer in an amount exceeding $5,000. For the years 1932 and 1933, affiliated returns were filed by the taxpayer and the subsidiary. (R. 16–17.)

Several years after 1936, the taxpayer was able to obtain authority to conduct intrastate business in California and the subsidiary was therefore dissolved and its assets transferred to the taxpayer (R. 17).

The taxpayer sought to deduct the 1936 deficit of $28,100.66 of its subsidiary as an ordinary and necessary expense of its own business. The Commissioner disallowed the deduction and assessed the deficiency under review (R. 6–8). The Board sustained the Commissioner's determination (R. 17–19), and the Circuit Court of Appeals affirmed (R. 70–79).

SUMMARY OF ARGUMENT

The item which the taxpayer seeks to deduct from its taxable income is an operating loss sustained by another corporation, its subsidiary. If as contended by the taxpayer the subsidiary should be assimilated to it the net operating deficit loses all significance for tax purposes. As principal the taxpayer would have to report all the income received through the agent and could establish its right to deductions against such income by iden-

tifying particular expenditures as taxes, operating expenses, rental, depreciation charges, and the like. The asserted net operating deficit of the subsidiary may well have resulted in large part from expenditures nondeductible for income tax purposes. The Board of Tax Appeals did not make any finding respecting the expenditures that produced this operating loss. On this agency theory therefore the taxpayer's case must fall by reason of failure of proof to establish a right to any deduction.

Even if the taxpayer had established that it paid particular and deductible expenses of its subsidiary no right to a deduction by the former would have been established. The expenses of the subsidiary are its expenses alone. The argument that the subsidiary can be assimilated to the parent for tax purposes is contrary to the general rule that a corporation must be respected as a separate taxpayer. It is clear, moreover, that Congress intended that rule to apply to such cases as this. Section 13 of the Revenue Act of 1936 levies a tax on the net income of every corporation. Moreover, the privilege of filing consolidated returns by affiliated corporations was withdrawn by Congress in the Revenue Acts of 1934 and 1936 with full appreciation that such action would require such corporations as the taxpayer's subsidiary to file a separate return. Accordingly, the expenses of the subsidiary are deductible by it and not by the taxpayer.

The contention that the accrual of the contractual obligation to make good the subsidiary's loss makes that item an ordinary and necessary expense of the taxpayer is likewise without merit. That obligation cannot be explained as one to pay for service rendered by the subsidiary. Its nature is such that it could only be made between a sole stockholder and its corporation—an obligation to contribute additional capital to the corporation if needed. Accordingly, the accrual is simply one for a capital expenditure increasing the taxpayer's investment in its subsidiary.

In any event the expenditure could not be regarded as that of the taxpayer. It simply reimbursed the subsidiary for its losses and the taxpayer's payment thereof, though under contract, was simply the payment of another's expense. Any other view would permit parent and subsidiary corporations to effect by formal contracts and book entries the filing of a consolidated return for a tax year when Congress had specifically denied them that privilege.

ARGUMENT

While there was a close business relation between the taxpayer and its subsidiary, Union Pacific Stages of California (referred to herein as Stages), the circumstances under which Stages was organized and operated disclose the unreality of regarding the two businesses as one. The California Railroad Commission would not in 1930

permit taxpayer, as a foreign corporation, to carry intrastate passengers in California. Accordingly, the taxpayer[1] organized Stages as a California corporation and the latter was authorized to and did carry both intrastate and interstate passengers in California through the tax year in question. Thus, notwithstanding their community of business interest, there was from the beginning a legal cleavage between the taxpayer and Stages—one inevitably resulting from the taxpayer's act of creating another corporation and surrendering thereto a portion of its former activities, albeit the result of business necessity.

Prior to enactment of the Revenue Act of 1934 the fact that the taxpayer was one corporation while Stages was another had no necessary significance for tax purposes. From the Revenue Act of 1918 through the Revenue Act of 1932 provision had been made by Congress for the filing of a single return by affiliated corporations.[2] Inasmuch as Stages was a corporation wholly owned by the taxpayer the consolidated return privilege meant that the former's income and

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[1] Apparently the taxpayer in turn was a subsidiary of the Union Pacific Railroad Co. See R. 3, 38, 48.

[2] Section 240 of the Revenue Acts of 1918, c. 18, 40 Stat. 1057; 1921, c. 136, 42 Stat. 227; 1924, c. 234, 43 Stat. 253; and 1926, c. 27, 44 Stat. 9; Section 141 of the Revenue Act of 1928, c. 852, 45 Stat. 791, and 1932, c. 209, 47 Stat. 169, provided for consolidated returns of affiliated corporations generally. Similar provision appears in Section 141 of the Internal Revenue Code, as amended by the Revenue Act of 1942, Public Law 753, 77th Cong., 2d Sess., Sec. 159.

expenses of operation could be offset by those of the latter. In fact, for the years 1932 and 1933 the taxpayer and Stages, as affiliated corporations, did file consolidated returns (R. 17).

In the Revenue Act of 1934, however, Congress retained the consolidated return provision only with respect to affiliated railroad operating and holding companies.[3] The privilege of offsetting for tax purposes the losses of a subsidiary corporation against the parent corporation's income was denied to all other types of corporations. This was done by Congress, moreover, with full appreciation of the fact that subsidiary corporations are often little more than departments of the parent and created merely to satisfy local law.[4] The

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[3] Revenue Act of 1934, c. 277, 48 Stat. 680:

"SEC. 141. CONSOLIDATED RETURNS OF RAILROAD CORPORATIONS.

"(a) *Privilege to File Consolidated Returns.*—An affiliated group of corporations shall, subject to the provisions of this section, have the privilege of making a consolidated return for the taxable year in lieu of separate returns. * * *

* * * * *

"(d) *Definition of 'Affiliated Group.'*—As used in this section an 'affiliated group' means one or more chains of corporations connected through stock ownership with a common parent corporation if—

* * * * *

"(3) Each of the corporations is either (A) a corporation whose principal business is that of a common carrier by railroad or (B) a corporation the assets of which consist principally of stock in such corporations and which does not itself operate a business other than that of a common carrier by railroad. * * *"

* * * * *

[4] See fns. 12 and 13, pp. 19–21, *infra*.

provisions of the Revenue Act of 1934 respecting consolidated returns appeared unchanged in the Revenue Act of 1936, save for the addition of certain electric railways to the definition of the affiliated railroad operating and holding companies entitled to file consolidated returns.[5] Not until the enactment of the Revenue Act of 1942 was the consolidated-return privilege again extended to corporations generally. (Section 159 of the Revenue Act of 1942, Public Law 753, 77th Cong., 2d Sess., amending Section 141 of the Internal Revenue Code (U. S. C., Title 26, Sec. 141).)

Under the Revenue Act of 1936, the taxpayer and Stages, affiliated bus companies rather than railroads, were not entitled to file a consolidated return. Despite this change in the statute, the taxpayer's attempt here is to offset against its own income for 1936 an alleged deficit of some $28,100.66 which was incurred in the operation of Stages' business.

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[5] Revenue Act of 1936:

"SEC. 141. CONSOLIDATED RETURNS OF RAILROAD CORPORATIONS.

* * * * *

"(d) *Definition of 'Affiliated Group.'*—

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"(3) * * * As used in this paragraph, the term 'railroad' includes a street, suburban, or interurban electric railway.

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I

ITS SUBSIDIARY'S NET LOSS IS NOT DEDUCTIBLE BY THE TAXPAYER

The contention is advanced, largely on the authority of *Southern Pacific Co.* v. *Lowe,* 247 U. S. 330, that Stages should be regarded as a mere agent and the deficit incurred in its operation held deductible by the taxpayer as a business expense on that ground alone.

Even if it is assumed, *arguendo,* that Stages was a mere agent or department of the taxpayer, the right to the claimed deduction is not thereby established. On the contrary, to be deductible for income-tax purposes the nature of an expenditure must be defined with considerable more precision than mere characterization as a net operating deficit on business transacted by an agent. Such a deficit, as well as not, may result from allocating to the agent charges that are not themselves deductible, i. e., federal income and excess-profits taxes, lobbying expenses, excessive depreciation, and the like. As a matter of fact it appears that one of Stages' principal expenses was "bus rental" (R. 63). If the buses rented were those owned by the taxpayer, as appears to be the case,* the incongruity of permitting the claimed deduction is clear. A principal could not directly claim a deduction for rent charged

* The contract between the taxpayer and Stages called for each party as lessee to pay five cents a mile while in possession and custody of the other's buses (R. 15, 59).

by him against his agent. Nor can such an item become deductible by visitation with a balance sheet and emergence as a "net operating deficit". Indeed, if Stages is to be assimilated to the taxpayer then any payment to it would simply be a transfer from the taxpayer's right hand to its left, and such a transaction is manifestly insufficient to establish deductibility of anything. Cf. *Higgins* v. *Smith*, 308 U. S. 473. Just as *Southern Pacific Co.* v. *Lowe, supra,* disregarded the dividend payment by the subsidiary to the parent, so here its application would result in disregarding the payment by the parent to the subsidiary.

Deductions for business expenses are not established for purposes of the Revenue Acts (or for accounting purposes either for that matter) by reference to the year's net gain or loss on all business done. One engaged in business directly or through an agent is required to account with greater detail. If Stages were merely an agent then the taxpayer was required to report the gross income from all transactions handled by its agent. *Maryland Casualty Co.* v. *United States*, 251 U. S. 342; *Huntington Nat. Bank* v. *Commissioner*, 90 F. 2d 876 (C. C. A. 6th). Its right to deductions against all its income could only be established as depreciation charges, taxes, operating expenses, and the like.

The rule is elementary that deductions are a

matter of legislative grace and that the burden is on the taxpayer to establish all elements of his claim thereto. *New Colonial Ice Co.* v. *Helvering*, 292 U. S. 435. The Board of Tax Appeals has not even made findings respecting the nature or deductibility of the items that produced Stages' net operating loss for 1936. It seems clear, therefore, that acceptance of the taxpayer's theory that Stages was merely its agent would require decision that it has not established its right to any deduction.

There is yet another reason why the "agency" theory cannot establish the taxpayer's right to a deduction on the basis of Stages' net operating loss for 1936. Stages cannot for tax purposes be regarded as a mere agent of the taxpayer; rather, the two must be regarded as separate and distinct.

This case does not involve a situation where a subsidiary has been designated to act as an agent, with the principal thereby disavowing the particular advantages of having the business done separately as that of the subsidiary. The so-called "Absorption Agreement" between Stages and the taxpayer expressly recognized that the relation between the two was merely that of parent and operating subsidiary and that the operation of buses in California was the business of Stages as a California corporation (R. 57). Nor does this case involve a transaction in which

Stages' role could be described as transitory or ephemeral.[1] Stages was an operating corporation whose stock was wholly owned by the taxpayer, organized as a separate and distinct corporation in an area where the taxpayer had been unable to secure authority for full operation.

It was of the essence that Stages be regarded as the legally responsible entity in applying to the California Railroad Commission for a permit to operate as an intrastate carrier. Had the application been made by Stages as agent for the taxpayer the permit would not have been granted. The permit issued under these circumstances, i. e., to Stages, was the one under which operations

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[1] As indicated in the brief for the respondent in *Moline Properties, Inc.* v. *Helvering*, No. 660, October Term, 1942, there are several decisions holding realty corporations nontaxable on sale of property in certain situations. Cf. *112 West 59th Street Corp.* v. *Helvering*, 68 F. 2d 397 (App. D. C.); *McInerney* v. *Commissioner*, 29 B. T. A. 1, affirmed, 82 F. 2d 665; *Abrams Sons' Realty Corp.* v. *Commissioner*, 40 B. T. A. 653.

Where the realty corporation has been utilized as a medium for business activity, however insignificant, the tax consequence of such an unambiguous business decision cannot be escaped. *Higgins* v. *Smith*, *supra*; *Burnet* v. *Commonwealth Imp. Co.*, 287 U. S. 415; *Palcar Real Estate Co.* v. *Commissioner*, 131 F. 2d 210 (C. C. A. 8th); *Salmon* v. *Commissioner*, 126 F. 2d 203 (C. C. A. 2d).

Consistently with these latter decisions it is the Government's position, developed in greater detail in the brief for the respondent in *Moline Properties, Inc.* v. *Helvering*, *supra*, that every corporation is subject to taxation and is taxable on gains from sales of its property when its "ownership" is simply corporate ownership for the benefit of its stockholder.

were continued for the tax year involved here. Nor was the separation of Stages from the taxpayer limited to the representation made to the California Railroad Commission. Accounts were separately kept for the two corporations. Stages had its own employees, buses, directors and corporate minute books. By contract Stages was in physical possession of equipment of the taxpayer while used in California. Indeed, it was provided that as the respective companies took over the custody and possession of the buses a payment to the owners of five cents per mile run by each bus should be made and the "lessee" would be responsible to the "lessor" for the buses of the "lessor" in the "lessee's" custody and possesssion. The separation and responsibility of Stages is further evidenced by the nature of the item that occasions this litigation—an adjustment of the accounts between the two corporations on the basis of the business done by each respectively. In light of the reason for Stages' organization and the nature of the business carried on by it through the tax year in question, the taxpayer cannot now disavow the former's separate existence or legal responsibility. There is nothing in the record that indicates that Stages was ever represented as the taxpayer's agent or as a myth. Actually, it was scrupulously represented as a separate corporation. In short, Stages was an operating subsidiary corporation engaged in conducting its own

business.[9] The business relation between the taxpayer and Stages, the former's ownership of the latter's stock, and the fact that they had common offices and officers, cannot convert Stages' role to that of a mere agent. Such an argument amounts to no more than a contention that Stages, should be disregarded as a separate and responsible entity for tax purposes.

This Court has often observed that, as a general rule, for tax purposes a corporation must be treated as an entity taxable as such distinct from its owner, even though there is but one stockholder and his or its relation with the corporation is therefore naturally close. *Burnet* v. *Commonwealth Imp. Co.*, 287 U. S. 415; *Dalton* v. *Bowers*, 287 U. S. 404; *Burnet* v. *Clark*, 287 U. S. 410; *New Colonial Ice Co.* v. *Helvering*, *supra*.[9] As stated in *Higgins* v. *Smith*, *supra* (p. 477)—

> A taxpayer is free to adopt such organization for his affairs as he may choose and having elected to do some business as a corporation, he must accept the tax disadvantages.[10]

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[9] The separate character of the subsidiary would defeat a claim that the taxpayer was doing business in California. Cf. *Cannon Mfg. Co.* v. *Cudahy Co.*, 267 U. S. 333.

[9] State tax statutes are similarly construed by the state courts. See *Superior Coal Co.* v. *Department of Finance*, 377 Ill. 282, 36 N. E. (2d) 354; *Northwestern Pacific R. R. Co.* v. *State Board*, 21 Adv. Cal. 557, 133 P. (2d) 400.

[10] See also *Gray* v. *Powell*, 314 U. S. 402, 414, where in discussing an analogous problem under the Bituminous Coal Act this Court said:

"• • • The choice of disregarding a deliberately chosen arrangement for conducting business affairs does not lie with the creator of the plan."

In accordance with these decisions Stages must be regarded as distinct for tax purposes from the taxpayer and it is elementary that one taxpayer cannot have the benefit of another's deductions. *New Colonial Ice Co.* v. *Helvering, supra.*

In attempting to escape the impact of these principles the taxpayer relies chiefly on *Southern Pacific Co.* v. *Lowe, supra,* and *Gulf Oil Corp.* v. *Lewellyn,* 248 U. S. 71, for the proposition that Stages as a wholly owned subsidiary should be assimilated for tax purposes to the taxpayer. As pointed out in the brief for the respondent in *Moline Properties, Inc.* v *Helvering,* No. 660, now before this Court, however, those cases do not support that proposition. The issue presented in both was whether post-1913 dividends to the taxpayer corporation from the pre-1913 earnings of wholly owned subsidiaries were to be regarded as income accruing to the taxpayer after 1913. The decision was that the taxpayers' relation with their wholly owned subsidiaries was such that the income accrued to the former before the 1913 tax date. In the opinions in those cases and in *Burnet* v. *Commonwealth Imp. Co., supra,* at pp. 419–420, this Court has made it abundantly clear that these cases rest on their peculiar facts and do not support the general proposition that a wholly owned corporation and its owner are identical for tax purposes.

The peculiar fact which was the basis for those decisions sharply limits their significance. This

Court was of the view that Congress, in the Income Tax Act of 1913, c. 16, 38 Stat. 114, 166, had made clear its intention that no income earned and available to a taxpayer prior to 1913 should be taxed as income accruing thereafter. Cf. *Peabody* v. *Eisner*, 247 U. S. 347, 349. It was this view of the expressed will of Congress that dictated assimilation of wholly owned subsidiaries to the parent corporation in determining when income accrued. Thus these decisions, at most, stand for the proposition that wholly owned corporations may be identified with their owners for tax purposes when required to effectuate an expressed Congressional policy.[11] See *New Colonial Ice Co.* v. *Helvering*, 292 U. S. 435, 442.

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[11] The case of *Weiss* v. *Stearn*, 265 U. S. 242, was one growing out of a corporate reorganization. The decision, that the interest of the stockholders in the new corporation represented the same interest they had in the old, was based on the constitutional principle respecting realization of income enunciated in *Eisner* v. *Macomber*, 252 U. S. 189. Hence, the decision in *Weiss* v. *Stearn*, *supra*, is not pertinent to the issue of statutory construction presented here, i. e., whether the taxpayer may take a deduction for its subsidiary's net loss. Cf. *New Colonial Ice Co.* v. *Helvering*, *supra*, at p. 439. Moreover, *Weiss* v. *Stearn*, *supra*, is of dubious vitality in any event. See *Marr* v. *United States*, 268 U. S. 536, 542; Magill, *Taxable Income* (1936), 64; Finkelstein, *The Corporate Entity and the Income Tax* (1935), 44 Yale L. J. 436, 446.

Certain other decisions assimilating a corporation to its owner for tax purposes may be explained as resting on the premise that effectuation of an expressed Congressional policy required such corporate veil-piercing. In this connection reference is made to the decisions in *Munson S. S. Line* v. *Commissioner*, 77 F. 2d 849 (C. C. A. 2d); *Conti-*

There is, however, no recognizable or identifiable Congressional policy that requires nonrecognition of Stages as an independent taxpayer. On the contrary, Section 13 of the Revenue Act of 1936, *supra*, and its predecessors and successors levies a tax on the *net* income of *every* corporation. From a consideration of other provisions of the Revenue Acts respecting corporate taxation it is clear that Congress intended by Section 13 to tax the net income of every corporation irrespective of the nature of its activity or the number of its stockholders. (The material in the brief for the respondent in *Moline Properties, Inc.* v. *Helvering*, No. 660, develops this thesis in greater detail.) Taxing every corporation on its net income requires, of course, that items deductible in arriving at Stages' net income cannot be deducted in arriving at the taxpayer's net income. If there could be any question respecting Congressional intention in Section 13 to tax separately the net income of every corporation, including subsidiary corporations, however, it is

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ental Oil Co. v. *Jones*, 113 F. 2d 557 (C. C. A. 10th), certiorari denied, 311 U. S. 687; and *Inland Development Co.* v. *Commissioner*, 120 F. 2d 986 (C. C. A. 10th).

The decision of this Court in *Higgins* v. *Smith*, *supra*, that the Commissioner may disregard corporations that are unreal or such transactions as are sham, is based on the presumed Congressional intention that mere forms shall not operate to reduce the public revenue. See brief for the respondent in *Moline Properties, Inc.*, v. *Helvering*, *supra*, for discussion of this case.

completely dispelled by consideration of the legislative history underlying elimination of the general provision for consolidated returns from the Revenue Acts of 1934 and 1936.

As seen above, from the Revenue Act of 1918 through the Revenue Act of 1932, c. 209, 47 Stat. 169, Congress had provided for consolidated returns by affiliated corporations. During consideration of the bill that became the Revenue Act of 1934 both the House and Senate Committees reported favorably on retention of the provision for consolidated return by all types of affiliated corporations.[12] On the floor of the Senate, however, Senator Borah moved to strike the entire provision explaining that "If the motion should prevail, all corporations would make their separate and individual reports" (Cong. Record, Vol. 78, Part 6, p. 6463). The debate on the motion and the committee reports, referred to above, indicate complete awareness of the fact that many subsidiary corporations are formed with respect

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[12] H. Rep. No. 704, 73d Cong., 2d Sess., p. 17 (1939–1 Cum. Bull. (Part 2), 554, 566–567):

"Your committee considered at length the question of abolishing the consolidated return. Our subcommittee originally recommended this action. The Treasury believed this policy undesirable. The Treasury pointed out that the one way to secure a correct statement of income from affiliated corporations is to require a consolidated return, with all inter-company transactions eliminated. Otherwise, profits and losses may be shifted from one wholly owned subsidiary to another, and their separate statements of income do not present an accurate picture of the earnings of the group as

to interstate businesses simply to satisfy the requirements of local authorities, that they exist as little more than departments of the parent, and that to require separate returns in such cases might cause hardship."[11] Notwithstanding these considerations the Senate adopted the amendment striking the consolidated return provision (Cong. Record, Vol. 78, Part 6, p. 6466). Subse-

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a whole. For all practical purposes the various subsidiaries, though technically distinct entities, are actually branches or departments of one enterprise. For these reasons, consolidated statements of income have been the rule for ordinary business purposes, and for 16 years, the income tax law has provided for consolidated returns. The administration of the income tax law is simpler with the consolidated return since it conforms to ordinary business practice; enables the Treasury to deal with a single taxpayer instead of many subsidiaries; and eliminates the necessity of examining the bona fides of thousands of intercompany transactions.

"Consequently, after careful consideration of the question, the committee decided that it would be undesirable to abolish the consolidated return at this time. It appeared in the hearings that such action would be especially burdensome to many corporations, such as the railroads, which are frequently obliged to maintain separate corporate structures in the several States in which they operate, although for all ordinary business and accounting purposes, the subsidiaries form a single operating system. * * *"

A similar statement appears in S. Rep. No. 558, 73d Cong., 2d Sess., p. 18 (1939–1 Cum. Bull. (Part 2) 586, 600).

[11] See excerpts from the Committee Reports set out in fn. 12, *supra*.

In the debate on Senator Borah's motion to eliminate the consolidated return provision the following statement was made by Senator Harrison (Cong. Record, Vol. 78, Part 6, p. 6464):

quently, in connection with a motion for reconsideration of this amendment Senator Borah made clear the understanding that the Conference Committee could acceptably make some provision for consolidated returns in cases where special hardship would otherwise result (Cong. Record, Vol. 78, Part 6, p. 6555). The Committee, however, extended the consolidated return prerogative only to affiliated railroad operating

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"It has been thought by the committee that it is necessary in some cases that consolidated returns be filed. It was pointed out by the railroads, for instance, that it was necessary for them to file consolidated returns, and it must not be forgotten by the Senate that certain States have laws respecting the doing of business by corporations, which make it necessary that a corporation doing business in a State must organize under its laws. As an example, the Postal Telegraph Co., which has to institute eminent-domain proceedings in order to construct its lines, and so forth, I am informed, has to incorporate in practically every State: and so there are practically 48 different corporations under it, but it has one bookkeeping process. * * *"

On discussion of a motion to reconsider adoption of his motion Senator Borah observed (Cong. Record, Vol. 78, Part 6, p. 6555):

"It must be conceded that there are some companies which ought not to be permitted to enjoy the benefits of consolidated returns. It is claimed that there are other companies which possibly might be excepted from the effect of the provision as to consolidated returns, and in fairness and justice excepted. * * * If, however, there are corporations which it would seem to some ought to be excepted, that matter may be taken care of by the conferees. * * *"

For discussion in the House reflecting this appreciation of the fact that subsidiaries may be formed merely to satisfy local law, see Cong. Record, Vol. 78, Part 6, p. 6409, Part 7, pp. 7829, 7831.

and holding companies" and the Revenue Act of 1934 was enacted with only that limited provision for consolidated returns (Revenue Act of 1934, Section 141, *supra*). As seen above, the only change relative to the consolidated return provision effected in the Revenue Act of 1936 was inclusion of certain electric railways in the definition of railroads. A provision for consolidated returns by all affiliated corporations did not again appear until enactment of the Revenue Act of 1942 (Section 159 of the Revenue Act of 1942, *supra*).

In light of the fact that Congress had clearly before it the situation of such subsidiary corporations as Stages, the legislative decision reflected in the Revenue Acts of 1934 and 1936, denying parent and subsidiary corporations the consolidated return provision, is a clear mandate that their income-tax liability must be separately determined under those acts. It is therefore

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"H. Rep. No. 1385, 73d Cong., 2d Sess., p. 23 (1939–1, Cum. Bull. (Part 2) 627, 633):

"Amendment No. 73: This amendment eliminates section 141 of the House bill, permitting the filing of consolidated returns. The House recedes with an amendment restoring the privilege of making a consolidated return (granted by section 141 of the House bill) to any affiliated group of corporations each of which is either (A) a corporation whose principal business is that of a common carrier by railroad or (B) a corporation the assets of which consist principally of stock in such corporations and which does not itself operate a business other than that of a common carrier by railroad."

even clearer here than in the cases above cited that the separate entity and tax responsibility of the subsidiary corporation must be respected. Hence, business expenses, depreciation charges, and the like, allocable to business done by Stages, are deductible by it alone and may not be deducted by the taxpayer.

II

PAYMENT OF ITS SUBSIDIARY'S NET LOSS FOR THE YEAR IS NOT DEDUCTIBLE BY THE TAXPAYER AS AN ORDINARY AND NECESSARY EXPENSE OF ITS BUSINESS

The alternative contention advanced is that, by virtue of its contractual obligation to reimburse Stages for any operating deficits, the taxpayer is entitled to accrue as its own business expense the amount of the deficit incurred by Stages in 1936. It may again be noted that if Stages were a mere agent of the taxpayer this contention as well would fail to establish the taxpayer's right to a deduction. As seen above, a principal's income tax returns must reflect, not the balance on the agent's operations, but all items of income and deductible expense resulting from the agent's transactions. Thus the contention that an accrual for a business expense can be taken on the basis of a contractual obligation to make up Stages' deficits must rest on recognition that Stages is an entity separate and distinct from the taxpayer for tax purposes.

The essence of this contention is that the accrual under the contract represented an obligation to pay for service rendered the taxpayer by Stages. In connection with the nature of this obligation, however, the contract giving rise thereto is significant. By the terms of this contract Stages undertook to turn over all its profits to the taxpayer and the taxpayer in turn undertook to reimburse Stages for any deficits incurred in its operations. (R. 57.) This is certainly not the sort of an arrangement the taxpayer would have made with an independent carrier. Under this contract the stock in Stages would have been worthless to anyone other than the taxpayer. The contract, therefore, must be regarded as one which only a sole stockholder would make with its corporation and one made in lieu of contributing adequate capital to the corporation at the outset.

The nature of payments to be made to Stages is further shown by the fact that they were not measured by its expense or losses incurred in serving the taxpayer, i. e., by coordinating their schedules.[15] Stages, in fact, was compensated for carriage of the taxpayer's passengers by allocation of revenue to it on the basis of motor-coach miles and charge against that revenue of expenses for

[15] The schedules were coordinated in all years and yet payment was made only in 1936, when a deficit occurred. This indicates that the payment was not for the service, but to maintain the subsidiary's capital.

the most part apportioned on the same basis (R. 40–41). It is clear that the 1936 deficit of Stages did not result because of particular service rendered the taxpayer, i. e., by reason of Stages' practice of synchronizing its operations with those of the taxpayer. The net loss, rather, was a general one resulting from all Stages' operations—intrastate and interstate as well. It is noteworthy that the Board of Tax Appeals held that the evidence did not disclose what portion of the loss was attributable to Stages' intrastate operations in California (R. 18).

Consideration of these factors makes it clear that the contract of the taxpayer to make good Stages' operating deficits is one pervaded by the stockholder-corporation relation. Any contribution to Stages under this contract must therefore be regarded as incident to the taxpayer's stockholder status.

It is well settled that a contribution by a stockholder to replenish a corporation's impaired capital at a time when the corporation continues to function must be treated as a capital expenditure. This is true even though the payment is made under an obligation assumed on original purchase of the stock, and therefore involuntary. *Wichita State Bank & T. Co.* v. *Commissioner,* 69 F. 2d 595 (C. C. A. 5th), certiorari denied, 293 U. S. 562; *First Nat. Bank in Wichita* v. *Commissioner,* 46 F. 2d 283 (C. C. A. 10th); *Peyton Du-Pont Securities Co.* v. *Commissioner,* 66 F. 2d 718 (C. C. A.

2d). Cf. *Magruder* v. *Supplee*, 316 U. S. 394 (taxes paid by one who purchases realty after the tax lien therefor has attached must treat such payments as additional cost of the property and not as deductible taxes). The rule can be no different in the case of a contribution to a subsidiary corporation by the parent.

The fact of the stockholder-corporation relation is the dominant characteristic and certainly the only adequate explanation for a contract of the sort here presented. Moreover, there is nothing of unfairness in the view that the reimbursement of a subsidiary's net loss by the parent represents a capital expenditure. The contribution merely adds to the parent's capital investment recoverable tax free on liquidation of the corporation.

Had the taxpayer adequately financed Stages at the outset and at that time contributed an amount equal to the net loss sustained in 1936, the advance would simply have operated to increase taxpayer's capital investment. The taxpayer cannot alter the character of its investment in Stages by reason of having deferred the investment until further capital was needed. For the reason, therefore, that the accrual of the obligation under the contract to make up Stages' deficits was the accrual of a capital expenditure, it is not deductible by the taxpayer. Cf. *Welch* v. *Helvering*, 290 U. S. 111.

There is yet another and alternative reason why the contention, that the taxpayer's contract

to bear Stages' deficits gave rise to a deductible business expense in 1936, is without merit. The contention is based on the fallacious assumption that their respective businesses can be viewed as a whole for tax purposes.

As seen above, Congress, in enacting the Revenue Act of 1934, and again in the Revenue Act of 1936, denied parent and subsidiary corporations the right to make consolidated tax returns. The legislative intent in so doing is clearly revealed as requiring proper allocation between subsidiary and parant of income and expenses, and separate reporting thereof for tax purposes by each. In the absence of any contract by the taxpayer to reimburse Stages for its operating losses, it is clear, as seen above, that the taxpayer could get no tax benefit from such losses. Is the situation altered by reason of the fact of the taxpayer's contract to reimburse Stages for such losses?

In the absence of any contract the loss would have been borne ultimately by the taxpayer as sole owner of Stages. That necessarily is true in any case of a parent and wholly owned subsidiary. The subsidiary's gains come to the parent and likewise the losses. Despite that, however, the requirement of the Revenue Acts of 1934 and 1936 that their income and expenses be separately reported can only mean that the operating losses of the subsidiary cannot be reported as a deduction by the parent. It seems clear that

there is no escape to be had from this rule of law by reason of the fact that there has been a formal contract between the corporations requiring the parent to shoulder the subsidiary's loss via a mere book entry—when in the very nature of things that would happen anyway. Nor does the language of the Revenue Act of 1936 permit such a formalistic matter to alter tax liability.

The language of Section 23, allowing deductions for ordinary and necessary business expenses, must be read against the legislative history of the decision to deny parent and subsidiary corporations the consolidated return and require instead separate and distinct reports of income and expenses by each. So read, it is clear that ordinary and necessary expenses can embrace only those of the taxpayer's business as distinguished from the business of its subsidiary or the business of both together. In other words, business expenses must be allocated so as to be the expense of the parent *or* the subsidiary and not the expense of both. This accords with previous decisions of this Court holding losses sustained by one taxpayer are not deductible by another even though there is a close business relation between the two and indeed one is owned by the other. *New Colonial Ice Co.* v. *Helvering*, 292 U. S. 435; *Dalton* v. *Bowers*, 287 U. S. 404; *Burnet* v. *Clark*, 287 U. S. 410. Cf. *Burnet* v. *Commonwealth Imp. Co., supra.*

The business of the taxpayer included neither interstate nor intrastate carriage in California. The net loss of Stages was, by the taxpayer's books, attributable solely to California carriage, and the soundness of the allocation method followed is not in issue. There is nothing in the record that in any way indicates that Stages sustained a net loss in 1936 because of any service it rendered the taxpayer, i. e., synchronization of their respective schedules. It follows, therefore, that the net loss reflected expenses, taxes, salaries, etc., allocable only to Stages' operation. Payment of that loss by the taxpayer would not make those expenses ordinary and necessary expenses of its business. Cf. *Welch* v. *Helvering,* 290 U. S. 111. Nor does the fact that the taxpayer had contracted to make the payment alter the case. At best it was only a contract to pay the business expenses of another and in such a situation the contractual element is not significant. *Deputy* v. *du Pont,* 308 U. S. 488. If business exigency cannot make such a payment a business expense of a parent corporation surely dignifying the situation with a contract will not alter the fact that the payment is simply of another's expenses.

At this point the decision of the English Court of Appeals in *Odhams Press, Ltd.* v. *Cook,* 56 T. L. R. 704, is of interest. There the parent corporation, a printing establishment, had cancelled on its books an amount owed it by a wholly

owned subsidiary, a publishing company, representing the subsidiary's net loss for the year. The parent corporation sought to deduct this amount as money laid out or expended for the purposes of the trade.

In denying the sought-for deduction the Lord Chancellor observed:

> No doubt it was better for the appellants that its subsidiary companies, and this one among them, should prosper, and not be weighed down with debts. The same would be equally true of any company holding shares in another company and having trading relations with it. It is tempting to treat what I have called the subsidiary company as if it was part and parcel of the appellants, but, as the Master of the Rolls points out, the two companies are separate taxable persons. The trade or business of one company, even though it may affect very closely the trade or business of another, is not the same as that other's trade or business. * * *

Viscount Maughan wrote an opinion to similar effect.

In harmony with this English case are domestic decisions denying parent corporations any deduction for payments to subsidiaries for operating losses notwithstanding a business relation between the two corporations. *Esmond Mills* v. *Commissioner*, 132 F. 2d 753 (C. C. A. 1st), pending on petition for certiorari, No. 865, this Term; *Walker* v.

Gulf & I. Ry. Co. of Texas, 269 Fed. 885 (C. C. A. 5th).[18]

In essence the taxpayer seeks to bridge the legal chasm between it and its subsidiary by a contract so as to effect a consolidated return reflecting the net operating loss of the subsidiary. The decision of Congress, however, to require such corporations to file separate and individual returns for the tax year in question precludes the taxpayer from so doing. After enactment of the Revenue Act of 1934 its choice was to dissolve Stages or accept the tax consequences. Having chosen to operate through Stages as a separate corporation for 1936, no arrangements for book entries which the taxpayer had with its subsidiary can defeat the Commissioner's right to restrict the taxpayer to deduction of expenses allocable solely to its business. *Higgins* v. *Smith,* 308 U. S. 473.

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[18] The unreported memorandum decision in *Shasta Water Co.* v. *Commissioner*, decided February 6, 1942 (Prentice-Hall B. T. A. Memorandum Decisions, par. 42077), allowed payments to a subsidiary as advertising expenses. The subsidiary advertised the taxpayer's separate business and thus the payments made to the subsidiary were an expense of the taxpayer's own business. The case did not turn on the stock relationship, but wholly on the business relationship. The payments were measured by the subsidiary's losses, but this would merely create a doubt whether the *amount* of the deduction was correct.

CONCLUSION

The judgment below should be affirmed.

Respectfully submitted.

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SUPREME COURT OF THE UNITED STATES.

No. 552.—October Term, 1942.

Interstate Transit Lines, Petitioner, *vs.* Commissioner of Internal Revenue. } On Writ of Certiorari to the United States Circuit Court of Appeals for the Eighth Circuit.

[June 14, 1943.]

Mr. Justice Reed delivered the opinion of the Court.

This case involves a claim by the taxpayer to treatment of itself and a subsidiary as a single taxable person. The writ of certiorari was granted because of uncertainties in this area of important federal tax law. See *Moline Properties, Inc.* v. *Commissioner*, No. 660, October Term, 1942, decided June 1, 1943, n. 1. Petitioner Interstate Transit Lines, sought to deduct $28,100.66 as an ordinary and necessary business expense for the year 1936. § 23(a), Revenue Act of 1936.[1] This sum represented a credit to its subsidiary Union Pacific Stages of California pursuant to a contract by which petitioner was to be liable for all operating deficits of the subsidiary. The claimed deduction was disallowed and a deficiency determined. The Board of Tax Appeals sustained the Commissioner and the Circuit Court of Appeals has affirmed the Board. *Interstate Transit Lines* v. *Commissioner*, 44 B. T. A. 957; 130 F. 2d 136.

Petitioner, a Nebraska corporation, operated an interstate bus transportation line between Illinois and California, and Missouri and Wyoming, and did an intrastate business in most of the states en route. Because of its foreign incorporation, petitioner was barred, under the California Railroad Commission's interpretation of California law, from obtaining a certificate of public convenience to do intrastate business in California. To avoid this situation, petitioner in 1930 organized Stages in California as its wholly owned subsidiary to do the business it was unable to do.

[1] 49 Stat. 1648:
"Sec. 23 Deductions from Gross Income.
"In computing net income there shall be allowed as deductions:
"(a) Expenses.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, . . ."

It contracted with Stages that Stages was to operate solely for petitioner's benefit and under petitioner's direction; all profits were to be paid to petitioner and it was to reimburse Stages for any operating deficit. In addition to its own intrastate business, Stages was to carry on all of petitioner's interstate business in California, the agreement providing that as each party's buses crossed the state line, the other became its lessee. The lessee was to pay the lessor five cents per mile operated by the bus in the lessee's custody. All this resulted in no change and no added expense in the business formerly done in respects other than accounting except for the addition to the gross revenues of the enterprise of the proceeds of intrastate California business. Petitioner kept Stages' accounts, managed its finances and paid its bills and payroll. Each month petitioner apportioned between the two companies the revenues and expenses on the basis of passenger and traffic mileage. On the books of each a "clearing account" with the other showed the absorption by petitioner of Stages annual deficit or profit. It is the 1936 operating deficit of Stages, entered on the books of both on December 31 of that year, which petitioner now seeks to deduct as its business expense. Some years after 1936, by reason of a change in California law or its interpretation, petitioner became able to conduct intrastate business in California. Consequently Stages was dissolved and its assets and franchises transferred to petitioner. In 1932 and 1933 consolidated income tax returns were filed by petitioner pursuant to § 141 of the Revenue Act of 1932, 47 Stat. 169, 213.

Whether phrased as the payment of an expense in a business conducted for a principal by an agent or as a case where equity and reality require that the separate corporate identities be ignored or as the incurring under contract of a necessary expense, petitioner's argument for its success depends on the contention that Stages' operating deficit is an expense of petitioner's business. Without this keystone the entire argument must fall. And we examine the argument in the light of the now familiar rule that an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer. *New Colonial Ice Co.* v. *Helvering*, 292 U. S. 435, 440; *Deputy* v. *du Pont*, 308 U. S. 488, 493. The decision of the two courts below is that this burden has not been met.

This is not the case of a mere branch or division of a business conducted solely for convenience's sake under a separate corporate form. Petitioner did an interstate bus business and was a corporation foreign to California. On the other hand the business of Stages in the tax year in question was both interstate and intrastate. For petitioner to engage in intrastate business in California was, on the findings, illegal. Thus, the businesses of the two companies were distinct. Cf. *Edwards* v. *Chile Copper Co.*, 270 U. S. 452, 454, 456; *Texas-Empire Pipe Line Co.* v. *Commissioner*, 127 F. 2d 220. Even assuming that the interstate business of Stages could be the business of the petitioner,[2] it follows that at most only that part of the deficit attributable to Stages' interstate business could be an expense of petitioner's business and petitioner could not conceivably deduct as a business expense the cost of Stages' intrastate business. There was no showing below as to the allocation of the deductions sought as between Stages' intrastate and interstate business. There is thus no record requiring a further examination of petitioner's argument since in the absence of affirmative proof to the contrary we must assume that the entire deficiency was found correctly by the Commissioner and that the deficit is attributable to Stages' intrastate business.

It is no answer to this defect of proof that petitioner was obligated by contract to assume Stages' deficit. The mere fact that the expense was incurred under contractual obligation does not of course make it the equivalent of a rightful deduction under § 23(a). That subsection limits permitted deductions to those paid or incurred "in carrying on any trade or business." The origin and nature, and not the legal form, of the expense sought to be deducted, determines the applicability of the words of § 23(a). *Deputy* v. *du Pont*, *supra*, 494. It was not the business of the taxpayer to pay the costs of operating an intrastate bus line in California. The carriage of intrastate passengers did not increase the business of the taxpayer. The profit earned on their carriage increased the taxpayer's profit but so would any other profitable activity wholly disconnected from the taxpayer's own business. As the Circuit Court pointed out, the assumption of the deficit was not dependent upon a corresponding service or benefit ren-

[2] Cf. Moline Properties, Inc. v. Commissioner, No. 660, decided June 1, 1943; Higgins v. Smith, 308 U. S. 473, 477, nn. 8-10.

dered to the petitioner by Stages in connection with petitioner's business. 130 F. 2d 136, 139.

In view of these conclusions, it is unnecessary to characterize the payment by petitioner as a capital expenditure or otherwise, or to decide whether if the record were complete petitioner and Stages should be treated as a taxable entity for the claimed purpose. Cf. *Moline Properties Inc.* v. *Commissioner, supra,* n. 2.

Affirmed.

SUPREME COURT OF THE UNITED STATES.

No. 552.—October Term, 1942.

Interstate Transit Lines, Petitioner, vs. Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Eighth Circuit.

[June 14, 1943.]

Mr. Justice Jackson, dissenting.

This taxpayer operated a bus system between Chicago and Los Angeles. It could not pick up intrastate passengers in California, as it did elsewhere, because the State denied foreign corporations permission to do so. In order to obtain local traffic to help carry the cost of operating the interstate buses, taxpayer organized a wholly owned and dominated California subsidiary. This contented the local authorities, and it was granted permission to carry local business. It took over buses arriving at the state line, operated them in California, thus performing a part of the taxpayer's agreements of through carriage and benefiting from local traffic to reduce the cost. It was a common-sense business arrangement, for the purpose of making its business profitable.

The taxpayer made a contract with the subsidiary, by which the subsidiary undertook the service; the parent company became entitled to the profits and assumed the losses. The taxpayer agreed to reimburse the subsidiary for any operating deficit. This, too, was a common-sense business arrangement. To pay its wholly owned subsidiary more would be pointless, for it would only come back. To pay it less would result in its bankruptcy to the injury of creditors. So the taxpayer agreed that the operating deficits should be the measure of its contractual obligation to the subsidiary.

There is no suggestion that this arrangement was for tax avoidance, or for that matter that it did not actually reduce taxpayer's costs and thus increase its tax liability. The Commissioner ruled, however, that the amount of operating deficit paid by the taxpayer was not a business expense.

To require the Commissioner in all cases to allow a deduction so fixed might be turned by the unscrupulous to tax evasion ends. It could then, through its controlled subsidiary, make expenditures not properly allowable as business expense, but get them allowed as part of the deficit assumed by contract. Of course the Commissioner is not obliged to allow this, or any other arrangement, when it is used as a cover for tax skullduggery. Examination of the items is open to the Commissioner. But this deduction has been denied, not for such reasons, but upon a legal theory which I think is erroneous.

The taxpayer took inconsistent positions: first, that the corporate entity of the subsidiary should be disregarded and the two companies taxed on a consolidated basis; second, that the amount was a proper deduction under the contract, which of course implies existence of two parties to contract. The Government, not to be outdone in the matter of inconsistency, denied the separate entity theory and also disregarded the contract, and argues to us "the contract of the taxpayer to make good Stages' operating deficits is one pervaded by the stockholder-corporation relation. Any contribution to Stages under this contract must therefore be regarded as incident to the taxpayer's stockholder status." So the Government says the payment was not a compensation for services which the contract provides that it was, but was a "capital contribution" which the contract says it was not.

I think there is no merit in the taxpayer's theory that the Commissioner must disregard the corporate entity of the subsidiary. If a taxpayer itself creates and uses a corporation, he cannot require the Commissioner to say it isn't there.

But on the other hand, if the Commission says there are two entities, it would seem that they would be able to contract with each other, one to perform a service and the other to pay a price. The service may be, and often is, one that the taxpayer could not perform for itself, but if it is hired to build up its business, I see no reason why its proper cost is not a business expense deduction. The price need not be a fixed one, but may be determinable by costs or other contingencies; but when fixed, its amount (barring use as a device to evade) is the amount of the deduction. Cost or "cost plus" is one of the Government's own methods of contracting. It is not an illicit method for a taxpayer to employ.

But it is urged that since the taxpayer could not itself pick up local business under California law, it cannot be the business of the taxpayer in a legal sense to have a subsidiary do so, and disbursements to have local business brought in are legally foreign to its business, although for its benefit. I do not suppose the taxpayer corporation can itself legally practice law or medicine, but I would suppose if it needed legal service for its business or thought it good business to supply medical attention to injured or ailing employees, the cost would be a business deduction, even though the agent was doing what the taxpayer could not legally do for itself. The taxpayer may not be authorized to run a newspaper or put up billboards, but if it contracted for services of those who are, in order to fill vacant seats in its buses, I do not suppose its cost would be disallowed for that reason.

This company has not violated the law, even of California. Indeed, it went to this trouble to comply with it. The fact that it used a subsidiary to benefit its business in areas where its own competence was lacking can hardly invalidate the arrangement, particularly since it is insisted that the subsidiary had separate legal and tax existence. If states create dummies, business men may utilize them so long as they keep within the law, and the function of the revenue laws is not to tell them how they shall manage business, but to see that what they do has proper tax consequences.

Since the decision of this case the Tax Court has held in a very similar case that where a wholly owned subsidiary exclusively performs services essential to the business of the parent corporation, advances made by the parent to meet the subsidiary's operating deficit are deductible as a business expense. *The Texas and Pacific Railway* v. *Commission*, No. 105730, March 25, 1943. I think this is a correct rule. Judge Harron there avoids the force of this case only upon the ground that the parent corporation here could not itself engage in the business done in its behalf by the subsidiary. That distinction is good enough to get the Tax Court away from a bad rule, but I see no reason why such a deduction should be available in case of an unnecessary subsidiary and be refused in the case of one needed to comply with state laws in making a profitable enterprise. I would reverse.

The CHIEF JUSTICE and Mr. Justice MURPHY join in this dissent.